

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Affirmative Action Plan

Pursuant to Section 3.03 of the Kentucky Retirement Systems Personnel Policies, the Kentucky Retirement Systems has implemented an Affirmative Action Plan to promote and assure equitable treatment of all persons who are now employed, being considered for employment, seeking employment, and who will be recruited for employment in the future. The Kentucky Retirement Systems has already taken substantial steps towards fulfilling the requirements of the Affirmative Action Plan, as described in Section 3.03(3) of the Personnel Policy.

The Kentucky Retirement Systems provides periodic training to its leadership team to ensure compliance with federal and state laws. Such training covers harassment based on all legally protected categories (race, color, sex, religion, national origin, age, and disability), anti discrimination laws in general, and reasonable accommodation and inquiries under the ADA.

The Kentucky Retirement Systems continues to seek appropriate recruitment sources for females and minorities.

The current employment statistics for the Kentucky Retirement Systems show that as of December 31, 2015, there are 262 full-time employees. There are 159 female employees, representing 60.69% of the staff, and 26 employees who are members of minority groups, representing approximately 9.92% of the staff. Females make up 56.86% of the leadership positions in the Kentucky Retirement Systems, while employees who are members of minority groups hold 5.88% of the leadership positions in the Kentucky Retirement Systems.

In order to establish clear long term-hiring goals for minorities and females, Kentucky Retirement Systems will follow the goals provided by the Commonwealth of Kentucky's Personnel Cabinet. The current goal for minority employment in State Government is 12.2% through December 31, 2015.

RECOMMENDATION: This memorandum is presented for informational purposes only.

KENTUCKY RETIREMENT SYSTEMS

OVERALL AND MINORITY FULL TIME EMPLOYMENT
BY TYPE OF EMPLOYMENT AND DIVISION
AS OF DECEMBER 31, 2015

KRS AREA/DIVISION

KRS EMPLOYMENT CATEGORY

	<u>LEADERSHIP</u>			<u>PROFESSIONAL</u>			<u>SUPPORT</u>			<u>TOTALS</u>		
	<u>Total</u>	<u>Minor.</u>	<u>(%)</u>	<u>Total</u>	<u>Minor.</u>	<u>(%)</u>	<u>Total</u>	<u>Minor.</u>	<u>(%)</u>	<u>Total</u>	<u>Minor.</u>	<u>(%)</u>
Executive Staff	5	0	0.0%	0	0	0.0%	2	0	0.0%	7	0	0.0%
Communications	1	0	0.0%	4	0	0.0%	0	0	0.0%	5	0	0.0%
Legal	3	1	33.3%	7	0	0.0%	5	0	0.0%	15	1	6.7%
Human Resources	1	0	0.0%	3	1	33.3%	0	0	0.0%	4	1	25.0%
Internal Audit	1	0	0.0%	2	1	50.0%	0	0	0.0%	3	1	33.3%
Administration	11	1	9.1%	16	2	12.5%	7	0	0.0%	34	3	8.8%
Accounting	3	0	0.0%	9	0	0.0%	0	0	0.0%	12	0	0.0%
Disability & Death	5	0	0.0%	18	1	5.6%	4	0	0.0%	27	1	3.7%
Employer Reporting Compliance & Education	3	0	0.0%	19	3	15.8%	0	0	0.0%	22	3	13.6%
Enterprise & Technology Services	6	0	0.0%	30	5	16.7%	5	0	0.0%	41	5	12.2%
Investments	3	0	0.0%	4	1	0.0%	1	0	0.0%	8	1	12.5%
Member Services	7	0	0.0%	35	3	8.6%	2	0	0.0%	44	3	6.8%
Membership Support	4	1	25.0%	20	1	5.0%	5	1	20.0%	29	3	10.3%
Procurement & Office Services	4	1	25.0%	0	0	0.0%	13	3	23.1%	17	4	23.5%
Retiree Health Care	3	0	0.0%	15	1	6.7%	2	0	0.0%	20	1	5.0%
Retiree Services (Payroll)	2	0	0.0%	6	2	33.3%	0	0	0.0%	8	2	25.0%
TOTALS	51	3	5.88%	172	19	11.05%	39	4	10.26%	262	26	9.92%

KENTUCKY RETIREMENT SYSTEMS

OVERALL AND MINORITY (FEMALE) FULL TIME EMPLOYMENT BY TYPE OF EMPLOYMENT AND DIVISION AS OF DECEMBER 31, 2015

KRS AREA/DIVISION

KRS EMPLOYMENT CATEGORY

	<u>LEADERSHIP</u>			<u>PROFESSIONAL</u>			<u>SUPPORT</u>			<u>TOTALS</u>		
	<u>Total</u>	<u>Female</u>	<u>(%)</u>	<u>Total</u>	<u>Female</u>	<u>(%)</u>	<u>Total</u>	<u>Female</u>	<u>(%)</u>	<u>Total</u>	<u>Female</u>	<u>(%)</u>
Executive Staff	5	2	40.0%	0	0	0.0%	2	2	100.0%	7	4	57.1%
Communications	1	1	100.0%	4	3	75.0%	0	0	0.0%	5	4	80.0%
Legal	3	2	66.7%	7	4	57.1%	5	5	100.0%	15	11	73.3%
Human Resources	1	1	100.0%	3	3	100.0%	0	0	0.0%	4	4	100.0%
Internal Audit	1	1	100.0%	2	2	100.0%	0	0	0.0%	3	3	100.0%
Administration	11	7	63.6%	16	12	75.0%	7	7	100.0%	34	26	76.5%
Accounting	3	2	66.7%	9	8	88.9%	0	0	0.0%	12	10	83.3%
Disability & Death	5	4	80.0%	18	15	83.3%	4	4	100.0%	27	23	85.2%
Employer Reporting Compliance & Education	3	2	66.7%	19	12	63.2%	0	0	0.0%	22	14	63.6%
Enterprise & Technology Services	6	2	33.3%	30	10	33.3%	5	1	20.0%	41	13	31.7%
Investments	3	0	0.0%	4	1	0.0%	1	1	0.0%	8	2	25.0%
Member Services	7	5	71.4%	35	18	51.4%	2	2	100.0%	44	25	56.8%
Membership Support	4	1	25.0%	20	10	50.0%	5	5	100.0%	29	16	55.2%
Procurement & Office Services	4	2	50.0%	0	0	0.0%	13	9	69.2%	17	11	64.7%
Retiree Health Care	3	3	100.0%	15	7	46.7%	2	2	100.0%	20	12	60.0%
Retiree Services (Payroll)	2	1	50.0%	6	6	100.0%	0	0	0.0%	8	7	87.5%
TOTALS	51	29	56.86%	172	99	57.56%	39	31	79.49%	262	159	60.69%

KENTUCKY RETIREMENT SYSTEMS

Board Meeting Public Participation Policy

The Kentucky Retirement Systems (KRS) Board of Trustees has adopted the following policies regarding public participation at meetings of the KRS Board:

1. Public comments may be allowed at meetings of the KRS Board of Trustees. Public comments will not be accepted at KRS Board committee meetings.
2. The Board shall only accept comments regarding items that are included on the meeting agenda.
3. Public comments will only be accepted during the portion of the meeting set aside for public comments. The portion of the meeting set aside for public comments, if any, will be noted on the agenda of each meeting.
4. The Board shall allot no more than a total of thirty (30) minutes for public comments at any regular or special meeting. No individual presentation shall exceed three (3) minutes. The Board Chair shall have the authority to limit or extend the amount of time for public or individual comments set forth in this section, unless determined by a majority vote of the full Board. Statements shall be timed by the Board Chair or designee and time limits will be strictly enforced.
5. A person who desires to speak to the Board shall register at the Board meeting room on the day of the meeting. Registration sheets shall customarily be available at least thirty (30) minutes prior to the scheduled start of the Board meeting, and registration shall close five (5) minutes before the scheduled start of the meeting. Required registration information shall include the name and address of the person providing the comments, the name of the organization (if any) the person represents, the topic(s) to be discussed, and, if the person is a pension system member, the name of the pension system in which the person participates.
6. Public comments are subject to the following rules:
 - a. A person who has registered to speak shall, at the appropriate time, be acknowledged by the Board Chair. The person shall state his/her first and last name before speaking and state the topic to be addressed.
 - b. Written comments may be submitted to the Board Chair by a speaker and copies shall be distributed to the full Board following the meeting.
 - c. No person may speak more than once on the same topic.
 - d. Comments shall be directed to the Board, not to individual Board members. Questions to the Board or individual board members will not be entertained.
 - e. Statements shall not be abusive or argumentative. No profane or vulgar language will be tolerated.
5. The Board chair shall enforce these rules and may, subject to appeal to the full Board, take actions necessary to maintain order at the Board meeting. Such actions may include, but are not limited to:
 - a. interrupting a person making a statement, if the statement is too lengthy, unduly repetitive or otherwise violates these rules; and
 - b. limiting the total amount of time devoted to public statements based on the number of persons wishing to make statements and the length of the Board's agenda.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board
FROM: William A. Thielen, Esq.
Executive Director
DATE: February 18, 2016
SUBJECT: Quarterly Reports of the Audit Committee

The Audit Committee held its quarterly meeting on February 4, 2016. The purpose of the meeting was to review and discuss, among other miscellaneous audit related items, the following:

➤ *Review of Investment Financial Reporting*

Please see the attached spreadsheet with findings, recommendations, and management's corrective action.

Request the Board of Trustees to approve the Investment Financial Audit Report.

➤ *Review of Investment Performance Audit*





An audit of Investment Performance was included on the fiscal year 2016 audit plan. This area received a risk score of 4.30 on the most recent risk assessment. A review of investment financials was performed for the period ending December 31, 2014. Included in the investment financials review, was an assessment of Kentucky Retirement Systems' (KRS) performance reporting. No exceptions were found. Accordingly, since investment performance has been recently assessed, with no exceptions found, and audit of investment performance is not likely to identify any unknown or unforeseen risk.

Request the Board of Trustees to approve the Investment Performance Audit memo.

- *Review of Quarterly Financial Statements 12/31/2015*
- *Review of Fiscal Year End June 30, 2015, End of Audit Requirements*
- *Review of Outstanding Invoices*
- *Review of Management Follow up on Audit Findings and Recommendations Summary Dashboard*
- *Review of Information Disclosure Incidents, 3rd Quarter Calendar Year 2015*
- *Review of Internal Audit Budget 9/30/2015*
- *Review of Anonymous Reporting Spreadsheet*
- *Review of Investment Compliance Report*
- *Status of Current Audits Memoranda*
- *County Employees Retirement System Board Election Memoranda*

RECOMMENDATION: The Audit Committee requests that the Board ratify the actions taken by the Audit Committee.

	Rating	Exception	Recommendation	Management Remediation	Date Completed	Date Verified
1	HIGH 	\$117,357 in management fees, that were wired as part of a Note to a private equity fund, were classified as capital investment.	Manually complete a template for this private equity fund beginning July 1, 2015, and send the template to the custodian.	Journal entries for 6/30/15, recording the management fees, note and interest receivable were completed. Capital account statements sent to KRS' custodian to record fees.	10/9/2015 1/4/2016	10/14/2015 1/19/2016
2	HIGH 	Management fees for 15 alternative investments managers appeared higher than agreed upon rate. KRS' investment department does not currently review management fees for alternative investments.	Review fees on capital account statements for accuracy, prior to paying the management fee.	The Deputy Controller drafted and provided procedures relating to verifying investment fees with the contract.	1/19/2016	1/19/2016
3	MODERATE 	KRS paid \$ 14,167,277.33 in management and performance fees in open-end funds that were reported on its financials under the equity method instead of the proportional share method	Manually complete a template for open-end funds beginning July 1, 2015, and make sure there is a requirement to complete a fee template in all subsequent contracts with private funds.	The Deputy Controller drafted and provided procedures relating to reconciling and reporting monthly or quarterly statements from KRS' external investment managers. Templates have been sent and the custodian is reporting fees for most of KRS' open-end funds. The Deputy Controller is working with the remaining funds and the custodian to resolve this issue.	1/19/2016 1/19/2016	1/19/2016 1/19/2016
4	MODERATE 	Fees were being reported by the custodian using the value accrued (\$13,599,175.36), and not value of actually paid (\$11,974,465.14) in management fees	Once manager fees are paid for a time period, the Statement of Change Report should reflect that value paid, not the amount accrued for that time period.	KRS' custodian was instructed to reverse the accruals for these managers going back to July 1, 2013, and undue the reversal of the actual investment fees paid	7/20/2015	7/24/2015
5	MODERATE 	The accrual schedule for four investment managers did not match the investment management contract. Upon notification by Compliance, the custodian adjusted the accrual schedule.	Perform a review of the accrual schedule at least annually to keep it current.	The Deputy Controller drafted and provided procedures relating to the annual review and update of the accrual schedule.	1/19/2016	1/19/2016
6	MODERATE 	The LPA for a private equity fund did not contain a clause outlining the removal of the general partner	KRS external counsel has prepared a privileged memo on this issue to which Compliance will defer.	While written procedures have not yet been drafted, as a result of a recommendation in a previous audit, KRS' General Counsel is now working on investment contracts during the negotiation and drafting process and will monitor this issue going forward.	1/19/2016	1/20/2016
7	MEDIUM 	KRS has entered into side letter agreements with two private equity funds, and their LPAs that do not have specific language to enable the general partner enter into side letter agreements.	KRS external counsel has prepared a privileged memo on this issue to which Compliance will defer.	While written procedures have not yet been drafted, as a result of a recommendation in a previous audit, KRS' General Counsel is now working on investment contracts during the negotiation and drafting process and will monitor this issue going forward.	1/19/2016	1/20/2016
8	MODERATE 	KRS is invested in four Private Equity funds that continue to exist beyond the terms in the LPA. KRS paid \$19,966 in management fees to one of the funds. The remaining three funds did not have any management fees.	one fund made a final distribution on August 26, 2015. Continue to monitor the three remaining funds, and stay on top of the General Partners with respect to following the dissolution game plan.	Since October, another fund has ended, with final residual payments due in 2016. Investment staff will enhance monitoring and documentation surrounding terms and extensions of private funds.	1/19/2016	1/20/2016
9	MODERATE 	A transfer agreement, only mentioning the pension portfolio for a Private Equity fund was completed for forty million dollars, but it was intended that ten percent of this investment be made by the insurance portfolio. This fund is in the dissolution phase.	It is not possible to remedy the contract paperwork. Continue with ten percent of the distributions going to the insurance portfolio.			
10	MEDIUM 	A former investment employee, who separated from KRS on September 30, 2014, did not have his access removed from KRS' custodian's workbench system until December 30, 2014.	Develop procedures to make sure workbench access has been removed for employees immediately after separation from KRS	The Deputy Controller drafted and provided procedures relating to removing employee's access from BNY Mellon's workbench.	12/15/2015	1/19/2016

11		There were two instances where services were provided by external investment counsel at a higher rate than KRS contracted.	Review the rates charged and the positions of the external legal staff providing services for contract compliance prior to paying the invoice	The General Counsel reviewed Reinhart's November 16, 2015 invoice for contract compliance with respect to the rates charged, for a specific position, and verify the title of the legal staff performing the work, prior to giving the invoice to the COD for the accounting department to process. This process will be continued going forward.	1/5/2016	1/5/2016
12		There were two instances where services were provided by external investment counsel's staff with positions (Administrative and Clerk) not contemplated in KRS' contract. This resulted in an overpayment of \$65.	Set a price, or address the pay rate for external counsel employees whose positions are not in the contract.	KRS' Executive Director signed an amendment, and an extension, to cover services until June 30, 2017, that addressed the pay for administrative staff. It is the contention of KRS' General Counsel that work performed by any person with a position not contemplated in the contract should not be paid.	7/22/2015	8/15/2015
13		SEC report 13F due on August 15, 2014, was filed for KRS' insurance portfolio on August 28, 2014. A filing was not performed for the pension portfolio due to KRS' log-in password expiring. SEC reports 13F due on November 17, 2014, were filed on December 12, 2014 for both the pension and insurance portfolios.	Filing SEC reports by the day they are due and monitoring EDGAR filing confirmations to avoid password expirations.	SEC report 13F due on November 16, 2015, was filed for KRS' pension portfolio on November 18, 2015. A filing was not performed for the insurance portfolio due to KRS' log-in password expiring.	12/16/2015	12/16/2015
KEY						
\$		Impact on KRS Financials				
		Process Adjustment recommended				

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: KRS Human Resources (HR) Committee Report

The Kentucky Retirement Systems' HR Committee met on Tuesday, February 9, 2016. An oral report of the Committee's actions and recommendations will be presented at the Board meeting. The Committee's agenda and the materials considered are attached to this memorandum.

RECOMMENDATION: The Executive Director recommends that the KRS Board of Trustees approve the recommendations and actions taken by the KRS Human Resources Committee.

**KENTUCKY RETIREMENT SYSTEMS
BOARD OF TRUSTEES**

**Human Resources Committee
Special Meeting
February 9, 2016, 9:00 a.m. ET
1270 Louisville Road, Frankfort, Kentucky**

AGENDA

1. Call to order
2. Approval of the December 3, 2015 meeting minutes
3. Consideration of a proposal to create a new Government Services/
Legislative Affairs Officer position
4. Consideration of a proposal to change the title of the Director, Division of
Enterprise and Technology Services position to Chief Technology Officer 1
5. Consideration of a proposal to change the title of the Chief Operations
Officer position to Deputy Executive Director/Chief Operations Officer
6. Consideration of a proposal to create a new Investment Operations Division,
including the creation of a Director, Division of Investment Operations
position
7. Consideration of a proposal to create a Benefits Quality Assurance Division,
including the creation of Director, Division of Benefits Quality Assurance
position
8. Consideration of the CBIZ compensation and classification study
recommendations
9. Discussion regarding future restructuring of the Communications Division
and Information Technology Division
10. Adjournment

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Human Resources Committee
J. T. Fulkerson, Chair
Keith Percy
David Rich
Randy K. Stevens
William Summers

FROM: William A. Thielen
Executive Director

DATE: February 9, 2016

SUBJECT: Creation of a new Government Services and Legislative Officer position

Historically, the KRS Executive Director has been primarily responsible for legislative and executive branch relations and communications. At one time, the KRS staff included a Legislative Liaison, who reported directly to the Executive Director and assisted the Executive Director with these day-to-day legislative and general government functions and responsibilities. However, the Legislative Liaison position was abandoned a number of years ago.

In the past few years, particularly with the greatly increased legislative focus on KRS, including the creation of the Public Pension Oversight Board, it has become increasingly difficult for the Executive Director to devote the amount of time necessary to legislative issues, building and maintaining legislative communications, and deal with various day-to-day general government issues. The current Executive Director has extensive experience with the Kentucky General Assembly and Kentucky state government in general; however, future Executive Directors may well not have this type of knowledge and expertise. It is critical that KRS develop on its staff the necessary knowledge and experience to assist the Executive Director in the performance of these functions and to create a more robust legislative presence on a daily basis and better legislative communications. In order to achieve this goal, we believe that the KRS Board should create this new staff position.

The position would be a Grade U, which is the same as other division directors. The intent is to transfer a current KRS staff member into this position. It would be a lateral transfer without any additional cost at this time.

The recommendation are being presented to the HR Committee for review and input prior to a presentation and recommendation to the full Board of Trustees. It is expected that implementation of any recommendations of the HR Committee adopted by the Board would be implemented on March 1, 2016.

RECOMMENDATION: The Executive Director urges the Human Resources Committee to recommend the creation of a new Government Services and Legislative Officer position to the full KRS Board of Trustees.

**KENTUCKY RETIREMENT SYSTEMS
CLASS SPECIFICATION**

CLASS TITLE: DRAFT GOVERNMENT SERVICES AND LEGISLATIVE OFFICER	
DATE CLASS ESTABLISHED: 03/01/2016	DATE OF LAST REVISION: 03/01/2016
SELECTION METHOD: NON-STATUS, NON-COMPETITIVE	SALARY: (MIN-MID) \$5,789- \$7,236 GRADE: U

MINIMUM REQUIREMENTS: MINIMUM REQUIREMENTS ARE COMPREHENSIVE STATEMENTS OF THE MINIMUM BACKGROUND AS TO EDUCATION, EXPERIENCE, AND OTHER QUALIFICATIONS WHICH WILL BE REQUIRED IN ALL CASES AS EVIDENCE OF AN APPOINTEE'S ABILITY TO PERFORM THE WORK PROPERLY.

EDUCATION: Bachelor's degree in business or public administration, economics, statistics, government or a related field. Master's Degree desirable.

EXPERIENCE: Requires extensive in-depth experience in governmental and legislative processes to ensure the candidate has the requisite knowledge, skills and abilities to accomplish agency objectives. Proficient writing and speaking skills required.

SUBSTITUTION FOR MINIMUM REQUIREMENTS

EDUCATION: A Master's Degree in business or public administration, economics, statistics, government or a related field will substitute for the experience requirement.

EXPERIENCE: Five (5) years experience in writing and analyzing legislative proposals or serving as a legislative employee will substitute for the bachelor's degree requirement.

SPECIAL REQUIREMENTS: (AGE, LICENSURE, REGULATION, ETC.)

None

CHARACTERISTICS OF THE CLASS: CHARACTERISTICS OF A CLASS ARE GENERAL STATEMENTS INDICATING THE LEVEL OF RESPONSIBILITY AND DISCRETION OF POSITIONS IN THAT JOB CLASSIFICATION.

Reviews, researches, publishes, provides highly technical materials relevant for general governmental and legislative purposes and education of membership at the request of the Executive Director or the KRS Board of Trustees; represents KRS before legislative committees and communicates with legislators, executive branch officials and others regarding KRS legislative issues and other general governmental matters, as directed by the KRS Executive Director or Board of Trustees; performs other duties as required.

EXAMPLES OF DUTIES OR RESPONSIBILITIES OF THE CLASSIFICATION: EXAMPLES OF DUTIES OR RESPONSIBILITIES ARE NOT TO BE CONSTRUED AS DESCRIBING WHAT THE DUTIES OR RESPONSIBILITIES OF ANY POSITION SHALL BE AND ARE NOT TO BE CONSTRUED AS LIMITING THE APPOINTING AUTHORITY'S ABILITY TO ADD TO, OR OTHERWISE ALTER THE DUTIES AND RESPONSIBILITIES OF A POSITION. THE USE OF AN INDIVIDUAL EXPRESSION OR ILLUSTRATION AS TO DUTIES OR RESPONSIBILITIES SHALL NOT BE REGARDED AS EXCLUDING ASSIGNMENT OF OTHERS NOT MENTIONED WHICH ARE OF SIMILAR KIND OR QUALITY.

Researches, develops, and writes informative, original, educational and/or legislative materials, as necessary and as requested, for the promotion of agency goals and programs. Confers with and provides assistance, advice and interpretation of rules, regulations, policies and procedures and legislative proposals and enactments to executive director, member agency officials, chief officers, division directors, attorneys, members and beneficiaries. Furnishes written assessments. Meets and confers with legislators and Legislative Research Commission staff concerning legislative proposals impacting the agency. Testifies at legislative, Public Pension Oversight Board and other entity hearings regarding agency interests. Speaks at meetings of constituency groups about agency issues. Determines effectiveness and appropriateness of existing policies/procedures, laws and regulations and makes recommendations for revisions. Assists legal staff to draft and/or revise legislative proposals. Represents the agency on task forces, committees, councils or meetings, as assigned. Serves as contact and referral agent to Governor's Office and Legislative Research Commission for constituency services. Using PC and various other pieces of office equipment, drafts original documents.

TYPICAL WORKING CONDITIONS AND UNIQUE PHYSICAL REQUIREMENTS: INCUMBENTS IN THIS CLASSIFICATION WILL TYPICALLY PERFORM THEIR PRIMARY JOB DUTIES UNDER THESE CONDITIONS, HOWEVER, THESE CONDITIONS MAY CHANGE ON OCCASION IN PERFORMING THE DUTIES OF AN INDIVIDUAL POSITION.

Work is typically performed in an office setting. Trips to legislative offices and General Assembly are required.

THE KENTUCKY RETIREMENT SYSTEMS DOES NOT DISCRIMINATE ON THE BASIS OF RACE, ETHNIC ORIGIN, COLOR, CREED, RELIGION, GENDER, SEXUAL ORIENTATION, AGE, DISABILITY OR POLITICAL AFFILIATION. THIS DOCUMENT IS AVAILABLE IN ANY ACCESSIBLE FORMAT UPON REQUEST TO THE HUMAN RESOURCES DIVISION: KENTUCKY RETIREMENT SYSTEMS.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Human Resources Committee
J. T. Fulkerson, Chair
Keith Percy
David Rich
Randy K. Stevens
William Summers

FROM: William A. Thielen
Executive Director

DATE: February 9, 2016

SUBJECT: Chief Technology Officer (CTO)

In early Fiscal Year 2015, KRS recognized the need to better align existing Technology personnel to meet several business needs including:

- Audit Issues resolution including Disaster Recovery requirements
- Infrastructure upgrades
- Tiers 1, 2, 3 support
- Pension Spiking management
- Expanding Data and Business Analysis needs
- Technology Director resignation/turnover
- Manager development
- Technology Strategic Planning

In April, the Information Security and Information Technology business areas were combined under one Division Director. During this period, our Technology team has made continual progress in meeting goals and objectives, improving technology support for our KRS business areas while functioning as a combined team. In reviewing CBIZ and other Technology organization structures, the title of Chief Technology Officer (CTO) or Chief Information Officer (CIO) is more commonly used both within private and government structures (ex: Kentucky Legislative Research Commission).

It is the recommendation of staff to change the Division Director (Technology) title to Chief Technology Officer. There are no changes in grade (W) or salary. The position would continue to report to the Chief Operations Officer.

The recommendations are being presented to the HR Committee for review and input prior to a presentation and recommendation to the full Board of Trustees. It is expected that implementation of any recommendations of the HR Committee adopted by the Board would be implemented on March 1, 2016.

RECOMMENDATION: The Executive Director asks the Human Resources Committee to review the recommendation and to make final recommendation regarding the title change to Chief Technology Officer to the KRS Board of Trustees.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Human Resources Committee
J. T. Fulkerson, Chair
Keith Peercy
David Rich
Randy K. Stevens
William Summers

FROM: William A. Thielen
Executive Director

DATE: February 9, 2016

SUBJECT: Recommended Change to Chief Operations Officer Title

At present, when the Executive Director is out of the office on vacation, a business trip, or otherwise not in a position to make necessary day-to-day decisions, it is unclear who has that authority. In order to establish a clear “chain of command”, it is recommended that the title of the Chief Operations Officer be changed to Deputy Executive Director/Chief Operations Officer. It is not the purpose of this recommendation, however, to create a line of succession as it relates to the Executive Director position.

RECOMMENDATION: The Executive Director asks that the Human Resources Committee recommend that the title of the Chief Operations Officer position be changed to Deputy Executive Director/Chief Operations Officer.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Human Resources Committee
J. T. Fulkerson, Chair
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FROM: William A. Thielen
Executive Director

DATE: February 9, 2016

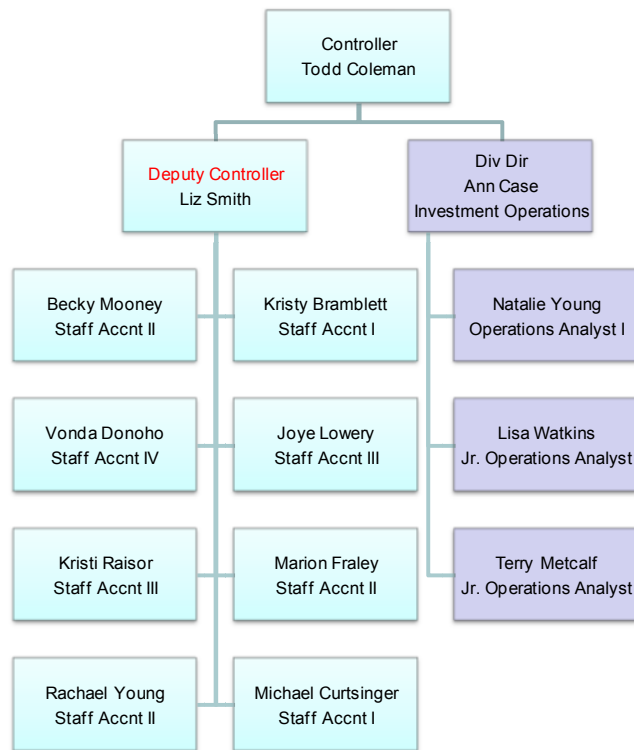
SUBJECT: Investment Operations

Beginning November 1, 2015, the KRS Deputy Controller, was assigned to an Investment Operations special detail along with two Jr. Investment Analysts. The special detail assignment included the following objectives:

- Improve Investment expense fee reporting to capture all fees by investment type and manager.
- Use standard monthly reports increase fee transparency by providing this information to KRS Investment Staff, KRS Investment Committee, Board of Trustees, PPOB, and interested public constituents.
- Expand financial statement integration and analysis.
- Provide an Operations/Accounting structure to facilitate daily interaction with our custodial Bank (BYN Mellon).
- Assist the KRS Investment staff in trend analysis and other data/financial reconciliations.

During this three-month period, the group has achieved these objectives and Accounting, Operations, and Investments recognize the need to make this an on-going business area. This business focus also conforms to best business practices from several of our larger Pension peers (ex: Ohio Public Employees Retirement System) and other entities utilizing BYN Mellon custodial banking services.

It is the recommendation of staff to make this a permanent Operations business team by forming an Investment Operations Division within Accounting with a dotted line reporting to the KRS Chief Investment Officer. The Division would be steered by a Director and staffed by three Analysts allocated from Investments and Accounting (no additional positions are being requested). The Director position would carry the same grade (U) as other KRS Division Directors. The Cash Management Accounting Manager would assume and fill the Deputy Controller position (T) on a permanent basis. The financial impact of these two promotions is mitigated by not backfilling an open Accounting Manager position (August 2015 retirement). The chart below depicts the proposed structure:



The recommendations are being presented to the HR Committee for review and input prior to a presentation and recommendation to the full Board of Trustees. It is expected that implementation of any recommendations of the HR Committee adopted by the Board would be implemented on March 1, 2016.

RECOMMENDATION: The Executive Director asks the Human Resources Committee to review the recommendation and to make final recommendation regarding the creation of the Investment Operations Division to the full KRS Board of Trustees.

**KENTUCKY RETIREMENT SYSTEMS
CLASS SPECIFICATION**

CLASS TITLE: Operations Analyst III		DRAFT
DATE CLASS ESTABLISHED: 03/01/2016	DATE OF LAST REVISION: 03/01/2016	
SELECTION METHOD: 100% QUAL	SALARY: (MIN-MID) \$4,350.00 - \$5,437.00	
	GRADE: R	

MINIMUM REQUIREMENTS: MINIMUM REQUIREMENTS ARE COMPREHENSIVE STATEMENTS OF THE MINIMUM BACKGROUND AS TO EDUCATION, EXPERIENCE, AND OTHER QUALIFICATIONS WHICH WILL BE REQUIRED IN ALL CASES AS EVIDENCE OF AN APPOINTEE'S ABILITY TO PERFORM THE WORK PROPERLY.

EDUCATION: Graduate of a college or university with a bachelor's degree in accounting, finance, statistics, economics or a business related field. Master's degree desirable.

EXPERIENCE: A minimum of 8 years of financial analyst experience.

SUBSTITUTION FOR MINIMUM REQUIREMENTS

EDUCATION: None

EXPERIENCE: None

SPECIAL REQUIREMENTS: Must have a clear understanding of the functionality of all asset classes.

CHARACTERISTICS OF THE CLASS: CHARACTERISTICS OF A CLASS ARE GENERAL STATEMENTS INDICATING THE LEVEL OF RESPONSIBILITY AND DISCRETION OF POSITIONS IN THAT JOB CLASSIFICATION.

Performs operational / back office duties for designated asset class or classes. Supports senior staff and management in assembling and analyzing financial data related to investments. Completes monthly, quarterly and annual reconciliations for designated investment managers. Assists in the set up and ongoing monitoring of external investment managers. Developing the knowledge and skills necessary for investment and financial analysis. Performs other duties as required.

EXAMPLES OF DUTIES OR RESPONSIBILITIES OF THE CLASSIFICATION: EXAMPLES OF DUTIES OR RESPONSIBILITIES ARE NOT TO BE CONSTRUED AS DESCRIBING WHAT THE DUTIES OR RESPONSIBILITIES OF ANY POSITION SHALL BE AND ARE NOT TO BE CONSTRUED AS LIMITING THE APPOINTING AUTHORITY'S ABILITY TO ADD TO, OR OTHERWISE ALTER THE DUTIES AND RESPONSIBILITIES OF A POSITION. THE USE OF AN INDIVIDUAL EXPRESSION OR ILLUSTRATION AS TO DUTIES OR RESPONSIBILITIES SHALL NOT BE REGARDED AS EXCLUDING ASSIGNMENT OF OTHERS NOT MENTIONED WHICH ARE OF SIMILAR KIND OR QUALITY.

Using PC and various programs, able to utilize the custodial bank system. Coordinates/reviews reconciliations of monthly, quarterly, and annual reports generated by custodial bank and investment managers. Assists in preparation of investment reports/spreadsheets as required. Interacts with Investment Staff, Custodial Bank and Investment Managers. Participates in Due Diligence process. Performs qualitative and quantitative analysis. Assist management with projects as required. Prepares/reviews journal entries for General Ledger Posting. Processes capital calls and distributions. Acts as a liaison to other divisions within KRS. Assists with preparing Investment Committee materials. Maintains appropriate databases. Pulls reports for open records requests. Utilizes, Excel, PowerPoint, PDF, and Word on a regular basis. Performs other duties as required.

TYPICAL WORKING CONDITIONS AND UNIQUE PHYSICAL REQUIREMENTS: INCUMBENTS IN THIS CLASSIFICATION WILL TYPICALLY PERFORM THEIR PRIMARY JOB DUTIES UNDER THESE CONDITIONS, HOWEVER, THESE CONDITIONS MAY CHANGE ON OCCASION IN PERFORMING THE DUTIES OF AN INDIVIDUAL POSITION.

Work is typically performed in an office setting. Responsibilities include managing to deadlines. Some travel is required to support the KRS Investment team.

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**KENTUCKY RETIREMENT SYSTEMS
CLASS SPECIFICATION**

CLASS TITLE: Operations Analyst II		DRAFT
DATE CLASS ESTABLISHED: 03/01/2016	DATE OF LAST REVISION: 03/01/2016	
SELECTION METHOD: 100% QUAL	SALARY: (MIN-MID) \$3,956.00 - \$4,944.00	
	GRADE: Q	

MINIMUM REQUIREMENTS: MINIMUM REQUIREMENTS ARE COMPREHENSIVE STATEMENTS OF THE MINIMUM BACKGROUND AS TO EDUCATION, EXPERIENCE, AND OTHER QUALIFICATIONS WHICH WILL BE REQUIRED IN ALL CASES AS EVIDENCE OF AN APPOINTEE'S ABILITY TO PERFORM THE WORK PROPERLY.

EDUCATION: Graduate of a college or university with a bachelor's degree in accounting, finance, statistics, economics or a business related field. Master's degree desirable.

EXPERIENCE: A minimum of 5 years of financial analyst experience.

SUBSTITUTION FOR MINIMUM REQUIREMENTS

EDUCATION: None

EXPERIENCE: None

SPECIAL REQUIREMENTS: Must have a clear understanding of the functionality of multiple asset class

CHARACTERISTICS OF THE CLASS: CHARACTERISTICS OF A CLASS ARE GENERAL STATEMENTS INDICATING THE LEVEL OF RESPONSIBILITY AND DISCRETION OF POSITIONS IN THAT JOB CLASSIFICATION.

Performs operational / back office duties for designated asset class or classes. Supports senior staff and management in assembling and analyzing financial data relating to investments. Completes monthly, quarterly and annual reconciliations for designated investment managers. Assists in the set up and ongoing monitoring of external investment managers. Developing the knowledge and skills necessary for investment and financial analysis. Performs other duties as required.

EXAMPLES OF DUTIES OR RESPONSIBILITIES OF THE CLASSIFICATION: EXAMPLES OF DUTIES OR RESPONSIBILITIES ARE NOT TO BE CONSTRUED AS DESCRIBING WHAT THE DUTIES OR RESPONSIBILITIES OF ANY POSITION SHALL BE AND ARE NOT TO BE CONSTRUED AS LIMITING THE APPOINTING AUTHORITY'S ABILITY TO ADD TO, OR OTHERWISE ALTER THE DUTIES AND RESPONSIBILITIES OF A POSITION. THE USE OF AN INDIVIDUAL EXPRESSION OR ILLUSTRATION AS TO DUTIES OR RESPONSIBILITIES SHALL NOT BE REGARDED AS EXCLUDING ASSIGNMENT OF OTHERS NOT MENTIONED WHICH ARE OF SIMILAR KIND OR QUALITY.

Using PC and various programs, able to utilize the custodial bank system. Coordinates/reviews reconciliations of monthly, quarterly, and annual reports generated by custodial bank and investment managers. Assists in preparation of investment reports/spreadsheets as required. Interacts with Investment Staff, Custodial Bank and Investment Managers. Participates in Due Diligence process. Performs qualitative and quantitative analysis. Assist management with projects as required. Prepares/reviews journal entries for General Ledger Posting. Processes capital calls and distributions. Assists with preparing Investment Committee materials. Utilizes, Excel, PowerPoint, PDF, and Word on a regular basis. Performs other duties as required.

TYPICAL WORKING CONDITIONS AND UNIQUE PHYSICAL REQUIREMENTS: INCUMBENTS IN THIS CLASSIFICATION WILL TYPICALLY PERFORM THEIR PRIMARY JOB DUTIES UNDER THESE CONDITIONS, HOWEVER, THESE CONDITIONS MAY CHANGE ON OCCASION IN PERFORMING THE DUTIES OF AN INDIVIDUAL POSITION.

Work is typically performed in an office setting. Responsibilities include managing to deadlines. Some travel is required to support the KRS Investment team.

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**KENTUCKY RETIREMENT SYSTEMS
CLASS SPECIFICATION**

CLASS TITLE: Operations Analyst I		DRAFT
DATE CLASS ESTABLISHED: 03/01/2016	DATE OF LAST REVISION: 03/01/2016	
SELECTION METHOD: 100% QUAL	SALARY: (MIN-MID) \$3,596.00 - \$4,495.00	
	GRADE: P	

MINIMUM REQUIREMENTS: MINIMUM REQUIREMENTS ARE COMPREHENSIVE STATEMENTS OF THE MINIMUM BACKGROUND AS TO EDUCATION, EXPERIENCE, AND OTHER QUALIFICATIONS WHICH WILL BE REQUIRED IN ALL CASES AS EVIDENCE OF AN APPOINTEE'S ABILITY TO PERFORM THE WORK PROPERLY.

EDUCATION: Graduate of a college or university with a bachelor's degree in accounting, finance, statistics, economics or a business related field. Master's degree desirable.

EXPERIENCE: A minimum of 2 years of financial analyst experience.

SUBSTITUTION FOR MINIMUM REQUIREMENTS

EDUCATION: None

EXPERIENCE: A Master's Degree will substitute for the 2 years of experience.

SPECIAL REQUIREMENTS:

CHARACTERISTICS OF THE CLASS: CHARACTERISTICS OF A CLASS ARE GENERAL STATEMENTS INDICATING THE LEVEL OF RESPONSIBILITY AND DISCRETION OF POSITIONS IN THAT JOB CLASSIFICATION.

Performs operational / back office duties for designated asset class or classes. Supports senior staff and management in assembling and analyzing financial data related to investments. Completes monthly, quarterly and annual reconciliations for designated investment managers. Assists in the set up and ongoing monitoring of external investment managers. Developing the knowledge and skills necessary for investment and financial analysis. Performs other duties as required.

EXAMPLES OF DUTIES OR RESPONSIBILITIES OF THE CLASSIFICATION: EXAMPLES OF DUTIES OR RESPONSIBILITIES ARE NOT TO BE CONSTRUED AS DESCRIBING WHAT THE DUTIES OR RESPONSIBILITIES OF ANY POSITION SHALL BE AND ARE NOT TO BE CONSTRUED AS LIMITING THE APPOINTING AUTHORITY'S ABILITY TO ADD TO, OR OTHERWISE ALTER THE DUTIES AND RESPONSIBILITIES OF A POSITION. THE USE OF AN INDIVIDUAL EXPRESSION OR ILLUSTRATION AS TO DUTIES OR RESPONSIBILITIES SHALL NOT BE REGARDED AS EXCLUDING ASSIGNMENT OF OTHERS NOT MENTIONED WHICH ARE OF SIMILAR KIND OR QUALITY.

Using PC and various programs, able to utilize the custodial bank system. Coordinates/reviews reconciliations of monthly, quarterly, and annual reports generated by custodial bank and investment managers. Assists in preparation of investment reports/spreadsheets as required. Interacts with Investment Staff, Custodial Bank and Investment Managers. Participates in Due Diligence process. Performs qualitative and quantitative analysis. Assist management with projects as required. Prepares/reviews journal entries for General Ledger Posting. Utilizes, Excel, PowerPoint, PDF, and Word on a regular basis. Performs other duties as required.

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**KENTUCKY RETIREMENT SYSTEMS
CLASS SPECIFICATION**

CLASS TITLE: Jr. Operations Analyst		DRAFT
DATE CLASS ESTABLISHED: 03/01/2016	DATE OF LAST REVISION: 03/01/2016	
SELECTION METHOD: 100% QUAL	SALARY: (MIN-MID) \$2,973.00 - \$3,716.00 GRADE: N	

MINIMUM REQUIREMENTS: MINIMUM REQUIREMENTS ARE COMPREHENSIVE STATEMENTS OF THE MINIMUM BACKGROUND AS TO EDUCATION, EXPERIENCE, AND OTHER QUALIFICATIONS WHICH WILL BE REQUIRED IN ALL CASES AS EVIDENCE OF AN APPOINTEE'S ABILITY TO PERFORM THE WORK PROPERLY.

EDUCATION: Graduate of a college or university with a bachelor's degree in accounting, finance, statistics, economics or a business related field.

EXPERIENCE: None

SUBSTITUTION FOR MINIMUM REQUIREMENTS

EDUCATION: None

EXPERIENCE: None

SPECIAL REQUIREMENTS: (AGE, LICENSURE, REGULATION, ETC.)

CHARACTERISTICS OF THE CLASS: CHARACTERISTICS OF A CLASS ARE GENERAL STATEMENTS INDICATING THE LEVEL OF RESPONSIBILITY AND DISCRETION OF POSITIONS IN THAT JOB CLASSIFICATION.

Performs operational / back office duties for designated asset class or classes. Supports senior staff and management in assembling and analyzing financial data related to investments. Completes monthly, quarterly and annual reconciliations for designated investment managers. Assists in the set up and ongoing monitoring of external investment managers. Developing the knowledge and skills necessary for investment and financial analysis. Performs other duties as required.

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Using PC and various programs, performs beginning level analysis of financial and investment data. Interacts with custodial banks for daily operations. Reconciles monthly, quarterly, and annual reports generated by custodial bank and investment managers. Assists in preparation of investment reports/spreadsheets as required. Utilizes, Excel, PowerPoint, PDF, and Word on a regular basis. Performs other duties as required.

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KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Human Resources Committee
J. T. Fulkerson, Chair
Keith Peercy
David Rich
Randy K. Stevens
William Summers

FROM: William A. Thielen
Executive Director

DATE: February 9, 2016

SUBJECT: Benefits Reorganization

In July 2015, KRS organized a special project team to focus on several business needs including:

- **Business Projects** – Tier 3 Member Self Service, Member Annual Statements, FileNet Upgrade, 2016 Pension Spiking Legislation, HB 62 – Agency Withdrawal, on-going 2013 SB 2 administration
- **Support for IT Projects** – testing for infrastructure upgrades including upgrade to KRS' business rules engine software and disaster recovery
- **Line-of-Business Testing** – liaison between IT and all areas of Benefits, data analysis for LRC and Actuary requests
- **Business Continuity** – knowledge transfer, staff development, succession planning, proficient and consistent testing in all areas of Benefits
- **Improved Efficiency** – allows business areas of Benefits to focus on day-to-day operations while continuing backlog reduction efforts

Both short and long term goals of this team include quality assurance of the information presented to KRS' membership for retirement planning while ensuring valid data analytics, which are relied upon for determining actuarial and/or legislative changes required of the Systems. A long term goal for this team is to be responsible for all initial and continued education training required of Benefits staff.

It is the recommendation of staff to expand this team on a permanent basis by forming a Division of Quality Assurance within Benefits. The Division would be steered by a Director and comprised of three (3) branches led by the following Retirement Program Managers: Pre-Retirement Audit Branch; Post-Retirement Audit Branch; and Benefits Support Branch. No additional positions are being requested for this new Division; instead, positions are being reallocated from the Divisions of Member Services and Disability and Death. A position of Retirement Program Manager, Grade Q, (currently detailed as Retirement Program Administrator, Grade R) would be modified to fill the position of Division Director, Grade U.

This Division would be responsible for all pre-retirement and post-retirement auditing of member accounts to ensure data integrity and would confirm that benefit amounts paid to KRS' members meet federal and state statutory and regulatory requirements. This team would also be accountable for the testing and support required for all of Benefits' processes, including those impacted by special business

and technology projects. This restructure will allow the remaining Benefits Divisions of Retiree Health Care, Retiree Payroll, Membership Support (Call Center), Member Services, and Disability and Death to focus on their day-to-day operations to meet the demands of KRS' 355,000 members without being distracted from the superfluous effort that is required to sustain our complex and multi-tiered pension systems.

The Division of Quality Assurance would also be responsible to review and analyze existing processes and operations to determine how improvements can be made to increase efficiency and effectiveness of each area within Benefits Services.

The recommendation are being presented to the HR Committee for review and input prior to a presentation and recommendation to the full Board of Trustees. It is expected that implementation of any recommendations of the HR Committee adopted by the Board would be implemented on March 1, 2016.

RECOMMENDATION: The Executive Director asks the Human Resources Committee to review the recommendation and to make final recommendations regarding the creation of the Division of Quality Assurance to the full KRS Board of Trustees.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Human Resources Committee
J. T. Fulkerson, Chair
Keith Peercy
David Rich
Randy K. Stevens
William Summers

FROM: William A. Thielen
Executive Director

DATE: February 9, 2016

SUBJECT: CBIZ Compensation and Organization Study Recommendations

In 2011, Kentucky Retirement Systems (KRS) retained CBIZ Human Capital Services (CBIZ) to analyze its current operations, organizational structure and staffing levels across divisions. The purpose of the review was to assist KRS in organizational planning as it deployed new technology that impacted how work is performed by KRS employees. In addition to a broad assessment of KRS' divisions, CBIZ evaluated the unique roles of KRS employees. Existing job documentation and employee and supervisor feedback were used to determine the suitability of current classifications.

CBIZ also conducted a compensation study, including a review of current compensation practices and the development of a new, market-based compensation plan. In order to assist KRS in implementing a structure that considers both market and internal factors, CBIZ matched KRS' positions to common positions in the market, creating a new salary structure and calculating the cost of incorporating the findings of the analysis in the organization's human resource policies and practices.

The studies and recommendations have been evaluated and reviewed by the Executive Director, Chief Investment Officer, Chief Benefits Officer, Chief Operations Officer, and General Counsel. It is the recommendation of this team for reasons that will be discussed at length at the meeting that the CBIZ recommendations should not be implemented.

RECOMMENDATION: The Executive Director recommends that the Human Resources Committee take no action regarding the CBIZ classification and compensation study recommendations.

MEMORANDUM

Date: January 26, 2016

To: Connie Davis, Director of Internal Audit

From: Karen Roggenkamp, Chief Operations Officer

Re: Financial Highlights – Quarter 2 FY 2016

KENTUCKY RETIREMENT SYSTEMS						
Net Position Comparison – Pension Fund (Period Ending December 31, 2015)						
	KERS	KHAZ	CERS	CHAZ	SPRS	TOTAL
FY 16 Net Position (NP)	\$2,116,054,816	\$525,688,968	\$6,107,028,669	\$1,988,082,139	\$227,095,231	\$10,963,949,823
FY 16 End of Period Quarter 1	\$2,327,783,171	\$552,467,903	\$6,440,799,858	\$2,078,201,686	\$247,227,583	\$11,646,480,202
Change in Net Position	(\$211,728,355)	(\$26,778,935)	(\$333,771,189)	(\$90,119,548)	(\$20,132,353)	(\$682,530,379)

Total Pension Net Assets were \$11.65 Billion at the beginning of Quarter 2 (FY) 2016 and decreased by 5.86% to \$10.96 Billion at December 31, 2015. The decrease of \$682.5 Million was comprised of the following:

- Total **Contributions** were \$638 Million (\$11.1M less than same period last year) primarily due to the one-time \$23M Bank of American settlement recorded last year.
- Overall **Investment Income** was negative \$338.7M compared to a negative \$138.8M reported for the 2nd Quarter of last year. The major drivers of the decline in Investment Income were:
 - The net appreciation in the Fair Value (FV) of Investments was negative \$378.4M compared to a negative \$242.4M same period last year. The Q2 FY 2016 Pension Investment performance was -1.08% compared to -0.92% for Q2 last year. The decline in FV was a result of unrealized losses experienced across all asset classes with the exception of Real Estate and Private Equity.
 - Although most asset classes experienced less than desirable returns, the equity markets seem to be hit the hardest experiencing losses of over \$300 million, primarily from the Non US markets. The decline in Fixed Income is primarily a result of the movement of assets to the Real Return account. This account was created to enhance the reporting of our investments.
 - Interest and Dividends earned during this reporting period declined by \$44.3M from prior year to \$79.1M. While less income was received across all asset classes, the largest decline was caused by reduced partnership income from Private Equity and Absolute Return investment performance.
 - Derivatives used by individual managers were able to assist in gaining some ground as the hedging investments offset the strong USD.
 - Investment expenses were \$41.2M compared to \$21.0M for the prior reporting period. Although this appears to be an expense increase, the difference is attributable to the reporting transparency change made in January 2015 to record all fees in Investment Expense. This change included fees related to Private Equity investments, which were netted against Investment assets in Q2 of last year. Normalized expenses would be comparable between reporting periods.
- Total **Deductions** were \$982M (an increase of \$33.8M). Benefits/Refunds totaled \$960.7M. The 3.7% increase was comparable to prior years. Administrative expenses were \$21.2M (\$0.6M lower than same period last year).

KENTUCKY RETIREMENT SYSTEMS						
Net Position Comparison – Insurance Fund (Period Ending December 31, 2015)						
	KERS	KHAZ	CERS	CHAZ	SPRS	TOTAL
FY 16 Net Position (NP)	\$648,830,127	\$425,564,484	\$1,860,011,467	\$1,026,927,801	\$158,341,794	\$4,119,675,674
FY 16 End of Period Quarter 1	\$665,637,927	\$439,112,712	\$1,920,944,927	\$1,056,480,313	\$164,714,559	\$4,246,890,439
Change in Net Position	(\$16,807,800)	(\$13,548,228)	(\$60,933,459)	(\$29,552,512)	(\$6,372,765)	(\$127,214,765)

Total Insurance Net Assets were \$4.25 Billion at the beginning of Quarter 2 (FY) 2016 and decreased by 3.0% to \$4.12 Billion for the period ending December 31, 2015. The decrease of \$127.2 Million was comprised of the following:

- Total **Contributions** were \$172.1M for the 2nd Quarter compared to \$175.6M for the same period last year. The change was due to a decrease in required employer contributions across all plans.
- Overall **Investment Income** was negative \$123.7M compared to negative \$41.4M for the same period last year. The major drivers of Investment Income were:
 - The net appreciation in the FV of Investments was negative \$139M compared to negative \$75.1M last period. The Q2 Insurance Trust Investment performance was -1.05% compared to -0.87% for Q2 last year. The depreciation in FV of Investments is a result of a declining market across all asset classes with the exception of Real Estate and Private Equity.
 - Although most asset classes experienced less than desirable returns, the equity markets seem to be hit the hardest experiencing losses of over \$120 million, primarily from the Non US markets. The decline in Fixed Income is primarily a result of the movement of assets to the Real Return account. This account was created to enhance the reporting of our investments.
 - Interest and Dividends were \$31.5M (decrease of \$10.2M from the prior year). While less income was received across all asset classes, the largest decline was a result in reduced partnership income from Private Equity and Absolute Return.
 - The Insurance Fund was able to gain some ground through Derivatives used by individual managers as the hedging investments offset the strong USD and the positive performance within the Private Equity Class.
 - Investment expenses were \$16.2M compared to \$8M same reporting period last year. Although this appears to be an expense increase, the difference is attributable to the reporting transparency change in January of 2015 to record all fees in Investment Expense. This change included Private Equity Investment fees, which were netted against Investment assets. Normalized expenses would be comparable between reporting periods.
- Total **Deductions** were \$176.2M (higher by \$12.9M compared to same period last year). Healthcare premiums accounted for the increase.

**KENTUCKY RETIREMENT SYSTEMS
COMBINING STATEMENTS OF NET POSITION
PENSION FUNDS
As of December 31, 2015
(Unaudited)(In Whole Dollars)**

	KERS	CERS	SPRS	CHAZ	KHAZ	2016	2015		
ASSETS									
Cash and Short-term Investments									
Cash Deposits	\$ 2,692,490	\$ 763,800	\$ 164,405	\$ 489,912	\$ 23,469	\$ 4,134,076	\$ 4,027,697	3%	
Short-term Investments	\$ 55,433,587	\$ 157,518,336	\$ 7,215,861	\$ 61,757,283	\$ 23,934,277	\$ 305,859,343	\$ 463,881,809	-34%	1
Total Cash and Short-term Investments	\$ 58,126,076	\$ 158,282,136	\$ 7,380,266	\$ 62,247,195	\$ 23,957,745	\$ 309,993,419	\$ 467,909,506		
RECEIVABLES									
Accounts Receivable	\$ 60,789,791	\$ 41,729,606	\$ 9,969,304	\$ 14,991,428	\$ 5,241,404	\$ 132,721,533	\$ 119,615,626	11%	2
Accounts Receivable - Investments	\$ 61,919,632	\$ 174,061,025	\$ 6,012,219	\$ 56,377,615	\$ 14,777,883	\$ 313,148,375	\$ 685,579,551	-54%	3
Accounts - Alternate Participation				\$ 101,245		\$ 101,245	\$ 107,629	-6%	
Total Receivables	\$ 122,709,423	\$ 215,790,631	\$ 15,981,523	\$ 71,470,289	\$ 20,019,287	\$ 445,971,152	\$ 805,302,806		
INVESTMENTS, AT FAIR VALUE									
Fixed Income	\$ 368,832,970	\$1,014,521,586	\$ 33,440,328	\$ 329,491,154	\$ 86,431,022	\$ 1,832,717,061	\$ 2,745,468,847	-33%	4
Public Equities	\$ 817,062,079	\$2,760,205,444	\$ 97,675,708	\$ 893,335,478	\$ 226,174,489	\$ 4,794,453,198	\$ 5,108,688,421	-6%	
Private Equities	\$ 317,985,103	\$ 626,125,619	\$ 24,597,257	\$ 210,733,984	\$ 60,481,871	\$ 1,239,923,835	\$ 1,314,849,177	-6%	
Derivatives	\$ 2,529,330	\$ 7,021,206	\$ 267,387	\$ 2,261,050	\$ 589,964	\$ 12,668,935	\$ 3,488,925	263%	5
Absolute Return	\$ 216,737,262	\$ 640,216,042	\$ 23,240,055	\$ 202,872,075	\$ 53,714,066	\$ 1,136,779,500	\$ 1,287,384,415	-12%	6
Real Return	\$ 167,906,666	\$ 507,187,432	\$ 17,230,917	\$ 160,259,285	\$ 38,707,259	\$ 891,291,560			
Real Estate	\$ 101,674,358	\$ 335,078,843	\$ 13,111,077	\$ 107,841,497	\$ 30,578,328	\$ 588,284,102	\$ 524,508,937	12%	7
Total Investments, at Fair Value	\$ 1,992,727,768	\$5,890,356,171	\$209,562,730	\$ 1,906,794,522	\$ 496,676,999	\$ 10,496,118,190	\$ 10,984,388,721		
FIXED/INTANGIBLE ASSETS									
Fixed Assets	\$ 824,547	\$ 1,523,100	\$ 8,845	\$ 138,126	\$ 82,433	\$ 2,577,051	\$ 2,569,251	0%	
Intangible Assets	\$ 5,919,584	\$ 9,960,922	\$ 100,005	\$ 826,734	\$ 493,581	\$ 17,300,826	\$ 16,254,290	6%	
Accumulated Depreciation	\$ (773,511)	\$ (1,425,380)	\$ (8,528)	\$ (129,016)	\$ (77,066)	\$ (2,413,501)	\$ (2,370,037)	2%	
Accumulated Amortization	\$ (2,933,934)	\$ (4,869,626)	\$ (58,058)	\$ (407,829)	\$ (235,432)	\$ (8,504,879)	\$ (6,748,633)	26%	8
Total Fixed Assets	\$ 3,036,686	\$ 5,189,017	\$ 42,263	\$ 428,015	\$ 263,516	\$ 8,959,497	\$ 9,704,871	-8%	
Total Assets	\$ 2,176,599,953	\$6,269,617,955	\$232,966,782	\$ 2,040,940,022	\$ 540,917,547	\$ 11,261,042,258	\$ 13,027,979,210		
LIABILITIES									
Accounts Payable	\$ 2,689,138	\$ 4,563,051	\$ 345,169	\$ 1,300,240	\$ 2,115,024	\$ 11,012,621	\$ 9,406,769	17%	9
Investment Accounts Payable	\$ 57,855,999	\$ 158,026,233	\$ 5,526,392	\$ 51,557,643	\$ 13,113,557	\$ 286,079,824	\$ 679,706,037	-58%	10
Total Liabilities	\$ 60,545,137	\$ 162,589,283	\$ 5,871,561	\$ 52,857,883	\$ 15,228,581	\$ 297,092,445	\$ 1,449,786,112		
Total Plan Net Assets	\$ 2,116,054,816	\$6,107,028,672	\$227,095,221	\$ 1,988,082,139	\$ 525,688,966	\$ 10,963,949,813	\$ 11,578,193,098		

NOTE - Variance Explanation

- 1 Short Term Investments is primarily comprised of the cash that is on hand with the custodial bank along with any small amounts of cash managers and brokers may have; therefore, the variance is driven by cash flow
- 2 The increase in receivables is primarily due to the generation of sick leave invoices and the increase in Installment Purchase System contracts.
- 3 Variance is a result of transactions activity which is based on each individual manager
- 4 Reduction in Fixed Income is primarily a result of the reallocation of assets with the creation of the Real Return Account for Financial Reporting
- 5 Derivatives include currency forwards/futures as permitted by KRS investment policy. Derivative income increases as the hedging investment offsets the strong USD.
- 6 The reduction in Absolute Return is a result of undesirable market conditions
- 7 Real Estate experienced positive returns resulting in an increase in market value
- 8 Additional Capitalization of intangible assets.
- 9 Increase in Leave Liability due to annual conversion of sick leave at calendar year end.
- 10 Variance is a result of transactions activity which is based on each individual manager

KENTUCKY RETIREMENT SYSTEMS
COMBINING STATEMENTS OF CHANGES IN NET POSITION
PENSION FUNDS

For the Six Months Ended December 31, 2015
(Unaudited)(In Whole Dollars)

	KERS	CERS	SPRS	CHAZ	KHAZ	2016	2015		
ADDITIONS									
Member Contributions	\$ 51,274,912	\$ 64,003,956	\$ 2,697,446	\$ 24,530,529	\$ 7,391,302	\$ 149,898,145	\$ 143,709,579	4%	
Employer Contributions	\$ 260,469,467	\$ 139,349,146	\$ 12,934,988	\$ 54,186,336	\$ 12,827,037	\$ 479,766,975	\$ 476,232,780	1%	
Pension Spiking Contributions	\$ 171,569	\$ 495,676	\$ 36,305	\$ 711,268	\$ 17,433	\$ 1,432,251	\$ 444,468	222%	1
Bank of America Settlement							\$ 23,000,000		
Health Insurance Contributions (HB1)	\$ 2,350,442	\$ 3,641,361	\$ 57,441	\$ 695,071	\$ 338,336	\$ 7,082,651	\$ 5,891,124	20%	2
Total Contributions	\$ 314,266,390	\$ 207,490,140	\$ 15,726,180	\$ 80,123,205	\$ 20,574,107	\$ 638,180,022	\$ 649,277,952		
INVESTMENT INCOME									
From Investing Activities									
Net Appreciation in FV of Investments	\$ (59,625,921)	\$ (223,113,118)	\$ (8,502,379)	\$ (69,302,393)	\$ (17,849,346)	\$ (378,393,156)	\$ (242,411,720)	56%	3
Interest/Dividends	\$ 13,773,299	\$ 45,405,476	\$ 1,593,508	\$ 14,486,940	\$ 3,819,224	\$ 79,078,448	\$ 123,386,095	-36%	4
Total Investing Activities Income	\$ (45,852,622)	\$ (177,707,643)	\$ (6,908,870)	\$ (54,815,452)	\$ (14,030,121)	\$ (299,314,709)	\$ (119,025,625)		
Investment Expense	\$ 7,224,837	\$ 23,275,921	\$ 802,959	\$ 7,825,375	\$ 2,080,366	\$ 41,209,457	\$ 21,031,340	96%	5
Net Income from Investing Activities	\$ (53,077,459)	\$ (200,983,563)	\$ (7,711,829)	\$ (62,640,827)	\$ (16,110,487)	\$ (340,524,165)	\$ (140,056,965)		
From Securities Lending Activities									
Securities Lending Income	\$ 378,793	\$ 1,127,003	\$ 38,516	\$ 361,336	\$ 92,039	\$ 1,997,685	\$ 1,523,914	31%	
Securities Lending Expense									
Security Lending Borrower Rebates	\$ (2,899)	\$ (116,105)	\$ (5,107)	\$ (37,488)	\$ (9,438)	\$ (171,037)	\$ 83,343	-305%	
Security Lending Agent Fee	\$ 57,253	\$ 186,467	\$ 6,543	\$ 59,824	\$ 15,221	\$ 325,308	\$ 178,511	82%	
Security Lending Commission Expense									
Net Income from Securities Lending	\$ 324,438	\$ 1,056,640	\$ 37,080	\$ 339,000	\$ 86,255	\$ 1,843,413	\$ 1,262,060	46%	6
Total Investment Income	\$ (52,753,020)	\$ (199,926,923)	\$ (7,674,750)	\$ (62,301,827)	\$ (16,024,232)	\$ (338,680,752)	\$ (138,794,905)		
Total Additions	\$ 261,513,370	\$ 7,563,217	\$ 8,051,430	\$ 17,821,378	\$ 4,549,875	\$ 299,499,270	\$ 510,483,048		
DEDUCTIONS									
Benefit Payments	\$ 459,125,398	\$ 321,362,809	\$ 28,045,937	\$ 105,494,783	\$ 29,399,832	\$ 943,428,758	\$ 908,179,249	4%	
Refunds	\$ 6,929,404	\$ 7,493,393	\$ 7,613	\$ 1,479,705	\$ 1,319,267	\$ 17,229,382	\$ 17,974,852	-4%	
Administrative Expenses	\$ 7,124,774	\$ 12,373,490	\$ 128,891	\$ 957,501	\$ 604,488	\$ 21,189,145	\$ 21,794,125	-3%	
Capital Project Expenses	\$ 62,149	\$ 104,714	\$ 1,342	\$ 8,936	\$ 5,223	\$ 182,364	\$ 239,360	-24%	7
Total Deductions	\$ 473,241,725	\$ 341,334,406	\$ 28,183,783	\$ 107,940,925	\$ 31,328,810	\$ 982,029,649	\$ 948,187,585		
Net Increase(Decrease) in Plan Net Assets	\$ (211,728,355)	\$ (333,771,189)	\$ (20,132,353)	\$ (90,119,548)	\$ (26,778,935)	\$ (682,530,379)	\$ (437,704,538)		
PLAN NET ASSETS HELD IN TRUST FOR PENSION BENEFITS									
Beginning of Period	\$ 2,327,783,171	\$ 6,440,799,858	\$ 247,227,583	\$ 2,078,201,686	\$ 552,467,903	\$ 11,646,480,202	\$ 12,015,897,645		
End of Period	\$ 2,116,054,816	\$ 6,107,028,669	\$ 227,095,231	\$ 1,988,082,139	\$ 525,688,968	\$ 10,963,949,823	\$ 11,578,193,107		

NOTE - Variance Explanation

- 1 The increase in Pension Spiking Contributions is due to the continuous generation of Pension Spiking Invoices.
- 2 The increase in Health Insurance Contributions is due to the increase in the number of employees contributing to HIC
- 3 Net Appreciation in FV of investments declined primarily as a result of unrealized losses experienced across all asset classes with the exception of Real Estate and Private Equity.
- 4 A significant reduction in partnership income from Private Equity, Absolute Return and Real Return.
- 5 The increase in Manager Fees is a result of KRS requiring more transparent reporting for Private Equity Managers. In January 2015, KRS began working with Private Equity Managers to begin reporting all fees. The first half of FY 2015 most Private Equity fees were netted giving the appearance of a large increase in fees for the first half of FY 2016.
- 6 Securities Lending Activity varies depending on the demands of the market
- 7 Capital Project expenses continue to decline as the project winds down. Remaining balance is less than \$575,000.

**KENTUCKY RETIREMENT SYSTEMS
COMBINING STATEMENTS OF NET POSITION
INSURANCE FUNDS
As of December 31, 2015
(Unaudited)(In Whole Dollars)**

	KERS	CERS	SPRS	CHAZ	KHAZ	2016	2015	
ASSETS								
Cash and Short-Term Investments								
Cash Deposits	\$ 328,239	\$ 541,545	\$ 12,632	\$ 30,355	\$ 39,273	\$ 952,044	\$ 486,352	96% 1
Short-term Investments	\$ 22,728,840	\$ 27,418,778	\$ 3,962,461	\$ 23,681,629	\$ 7,874,813	\$ 85,666,521	\$ 192,981,677	-56% 2
Medicare Drug Deposit	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 100,064	
Total Cash and Short-term Investments	\$ 23,057,080	\$ 27,960,323	\$ 3,975,093	\$ 23,711,984	\$ 7,914,086	\$ 86,618,564	\$ 193,568,094	
RECEIVABLES								
Accounts Receivable	\$ 13,041,530	\$ 11,269,427	\$ 862,127	\$ 5,842,181	\$ 1,490,103	\$ 32,505,368	\$ 33,040,928	-2%
Investment Accounts Receivable	\$ 23,228,766	\$ 65,303,209	\$ 5,532,115	\$ 36,058,726	\$ 14,979,558	\$ 145,102,373	\$ 277,769,075	-48% 3
Total Receivables	\$ 36,270,296	\$ 76,572,635	\$ 6,394,241	\$ 41,900,907	\$ 16,469,662	\$ 177,607,741	\$ 310,810,004	
INVESTMENTS, AT FAIR VALUE								
Fixed Income	\$ 173,462,410	\$ 484,065,935	\$ 40,667,731	\$ 267,526,043	\$ 110,748,691	\$ 1,076,470,810	\$ 1,273,625,411	-15% 4
Public Equities	\$ 254,044,076	\$ 704,077,615	\$ 59,058,111	\$ 381,498,313	\$ 168,287,855	\$ 1,566,965,971	\$ 1,646,699,035	-5%
Private Equities	\$ 36,021,382	\$ 179,292,173	\$ 15,795,011	\$ 100,154,664	\$ 34,208,578	\$ 365,471,808	\$ 323,112,061	13% 5
Derivatives	\$ 734,416	\$ 2,133,423	\$ 184,898	\$ 1,160,190	\$ 495,707	\$ 4,708,633	\$ 1,372,934	243% 6
Absolute Return	\$ 67,941,729	\$ 192,840,944	\$ 16,905,168	\$ 108,013,274	\$ 45,086,192	\$ 430,787,307	\$ 439,014,351	-2%
Real Return	\$ 47,039,208	\$ 153,939,904	\$ 11,672,968	\$ 81,744,756	\$ 32,916,749	\$ 327,313,585		
Real Estate	\$ 32,978,073	\$ 100,492,718	\$ 8,944,031	\$ 55,013,296	\$ 23,803,554	\$ 221,231,672	\$ 196,545,961	13% 7
Total Investments, at Fair Value	\$ 612,221,295	\$ 1,816,842,713	\$ 153,227,917	\$ 995,110,536	\$ 415,547,325	\$ 3,992,949,786	\$ 3,880,369,752	
Total Assets	\$ 671,548,670	\$ 1,921,375,671	\$ 163,597,251	\$ 1,060,723,426	\$ 439,931,073	\$ 4,257,176,091	\$ 4,630,992,069	-8%
LIABILITIES								
Accounts Payable	\$ -	\$ 7,683	\$ -	\$ 2,215	\$ 3,927	\$ 13,825	\$ 24,331	-43% 8
Investment Accounts Payable	\$ 22,718,533	\$ 61,356,520	\$ 5,255,458	\$ 33,793,409	\$ 14,362,661	\$ 137,486,582	\$ 258,871,291	-47% 9
Total Liabilities	\$ 22,718,533	\$ 61,364,203	\$ 5,255,458	\$ 33,795,625	\$ 14,366,589	\$ 137,500,407	\$ 505,139,842	
Total Plan Net Assets	\$ 648,830,137	\$ 1,860,011,468	\$ 158,341,793	\$ 1,026,927,801	\$ 425,564,484	\$ 4,119,675,684	\$ 4,125,852,227	

NOTE - Variance Explanation

- 1 Variance is a result of continuous fluctuation of deposits and transactions that flow through the cash account.
- 2 Short Term Investments is primarily comprised of the cash that is on hand with the custodial bank along with any small amounts of cash managers and brokers may have; therefore, the variance is driven by cash flow
- 3 Variance is a result of transactions activity which is based on each individual manager
- 4 Reduction in Fixed Income is primarily a result of the reallocation of assets with the creation of the Real Return Account for Financial Reporting
- 5 The increase is due to positive performance and additional funding of managers.
- 6 Derivatives include currency forwards/futures as permitted by KRS investment policy. Derivative income increases as the hedging investment offsets the strong USD
- 7 Real Estate experienced positive returns resulting in an increase in market value.
- 8 Reduction due to change in processing of Insurance Admin Fees.
- 9 Variance is a result of transactions activity which is based on each individual manager

KENTUCKY RETIREMENT SYSTEMS
COMBINING STATEMENTS OF CHANGES IN NET POSITION
INSURANCE FUNDS
For the Six Months Ended December 31, 2015
(Unaudited)(In Whole Dollars)

	KERS	CERS	SPRS	CHAZ	KHAZ	2016	2015	
ADDITIONS								
Employer Contributions	\$ 66,758,713	\$ 53,067,053	\$ 5,258,513	\$ 33,980,057	\$ 7,854,814	\$ 166,919,149	\$ 170,369,002	-2%
Insurance Premiums	\$ 125,414	\$ 318,286	\$ 235	\$ 4,051	\$ 7,545	\$ 455,531	\$ 398,016	14% 1
Retired Reemployed Healthcare	\$ 1,926,329	\$ 1,934,091	\$ 4,251	\$ 438,834	\$ 399,277	\$ 4,702,782	\$ 4,841,066	-3%
Total Contributions	\$ 68,810,456	\$ 55,319,430	\$ 5,262,999	\$ 34,422,941	\$ 8,261,636	\$ 172,077,461	\$ 175,608,083	
INVESTMENT INCOME								
From Investing Activities								
Net Appreciation in FV of Investments	\$ (24,635,109)	\$ (61,546,101)	\$ (5,160,359)	\$ (32,843,292)	\$ (14,803,213)	\$ (138,988,074)	\$ (75,097,714)	85% 2
Interest/Dividends	\$ 5,070,126	\$ 14,216,588	\$ 1,190,211	\$ 7,718,363	\$ 3,293,400	\$ 31,488,688	\$ 41,643,468	-24% 3
Total From Investing Activities	\$ (19,564,983)	\$ (47,329,513)	\$ (3,970,148)	\$ (25,124,929)	\$ (11,509,813)	\$ (107,499,385)	\$ (33,454,246)	
Investment Expense	\$ 1,597,524	\$ 7,918,128	\$ 657,619	\$ 4,428,276	\$ 1,553,401	\$ 16,154,948	\$ 7,975,674	103% 4
Net Income from Investing Activities	\$ (21,162,507)	\$ (55,247,641)	\$ (4,627,767)	\$ (29,553,205)	\$ (13,063,215)	\$ (123,654,333)	\$ (41,429,920)	
From Securities Lending								
Securities Lending Income	\$ 102,150	\$ 293,197	\$ 24,079	\$ 160,275	\$ 67,406	\$ 647,107	\$ 490,274	
Securities Lending Expense								
Security Lending Borrower Rebates	\$ (3,992)	\$ (9,245)	\$ (1,074)	\$ (4,731)	\$ (2,549)	\$ (21,590)	\$ (179,017)	
Security Lending Agent Fees	\$ 15,921	\$ 45,365	\$ 3,773	\$ 24,751	\$ 10,494	\$ 100,305	\$ 56,269	
Net Income from Securities Lending	\$ 90,221	\$ 257,077	\$ 21,379	\$ 140,256	\$ 59,460	\$ 568,393	\$ 613,022	-7%
Total Net Income from Investments	\$ (21,072,286)	\$ (54,990,564)	\$ (4,606,387)	\$ (29,412,949)	\$ (13,003,754)	\$ (123,085,941)	\$ (40,816,898)	
Total Additions	\$ 47,738,170	\$ 328,866	\$ 656,611	\$ 5,009,993	\$ (4,742,119)	\$ 48,991,521	\$ 134,791,186	
DEDUCTIONS								
Healthcare Premiums Subsidies	\$ 63,067,087	\$ 58,754,283	\$ 6,986,940	\$ 34,333,018	\$ 8,742,613	\$ 171,883,941	\$ 159,821,248	8%
Administrative Expense	\$ 346,237	\$ 299,910	\$ 26,871	\$ 142,928	\$ 40,649	\$ 856,595		
Self Funded Healthcare Costs	\$ 1,129,688	\$ 2,202,584	\$ 15,523	\$ 86,338	\$ 22,713	\$ 3,456,845	\$ 3,509,300	-1%
Excise Tax Insurance	\$ 2,958	\$ 5,549	\$ 42	\$ 220	\$ 135	\$ 8,904	\$ 9,194	-3%
Total Deductions	\$ 64,545,970	\$ 61,262,325	\$ 7,029,376	\$ 34,562,505	\$ 8,806,109	\$ 176,206,285	\$ 163,339,742	
Net Increase(Decrease) in Plan Net Assets	\$ (16,807,800)	\$ (60,933,459)	\$ (6,372,765)	\$ (29,552,512)	\$ (13,548,228)	\$ (127,214,765)	\$ (28,548,556)	
NET PLAN ASSETS HELD IN TRUST								
INSURANCE BENEFITS								
Beginning of Period	\$665,637,927	\$1,920,944,927	\$164,714,559	\$ 1,056,480,313	\$ 439,112,712	\$ 4,246,890,439	\$ 4,154,400,773	
End of Period	\$648,830,127	\$1,860,011,467	\$158,341,794	\$ 1,026,927,801	\$ 425,564,484	\$ 4,119,675,674	\$ 4,125,852,217	

NOTE - Variance Explanation

- 1 The increase in Insurance Premiums is due to an Increase in retirees
- 2 Net Appreciation in FV of Investments declined primarily as a result of unrealized losses experienced across all asset classes with the exception of Real Estate and Private Equity.
- 3 A significant reduction in partnership income from Private Equity, Absolute Return and Real Return.
- 4 The increase in Manager Fees is a result of KRS requiring more transparent reporting for Private Equity Managers. In January 2015, KRS began working with Private Equity Managers to begin reporting all fees. The first half of FY 2015 most Private Equity fees were netted giving the appearance of a large increase in fees for the first half of FY 2016.



KENTUCKY RETIREMENT SYSTEMS

William A. Thielen, Executive Director

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MEMORANDUM

Date: January 28, 2016

To: Mr. Mike Cherry, Chair
Audit Committee of the Board of Trustees

From: Ann M. Case, CGAP, CRMA
Deputy Controller

Re: **Financial Analysis of the Pension Fund**

Attached are three spreadsheets that have been included to better assist the board in understanding the funding obstacles that KRS faces. The following key points are noted:

- Asset Trends – All plans are experiencing a decline in assets due to unrealized losses driven by the current market conditions.
- Cash inflows from all plans have been impacted due to lower interest and dividend payments at the end of December 2015.
- Cash outflows are increasing in the 3% to 3.7% range for benefits payments related to Tier 1 retirements.
- KERS and SPRS cash flow projections for the remainder of FY 2016 will become more challenging if market conditions continue their current trend.

KENTUCKY RETIREMENT SYSTEMS
Asset Trends by Plan
Pension Fund
As of December 31, 2015 - 2014

	12/31/2015	6/30/2015	12/31/2015	6/30/2015	12/31/2015	6/30/2015	12/31/2015	6/30/2015	12/31/2015	6/30/2015
	KERS		KHAZ		CERS		CHAZ		SPRS	
ASSETS										
Cash Deposits	2,692,490	1,738,743	23,469	161,757	763,800	1,556,216	489,912	582,717	164,405	215,325
Short-term Investments	55,433,587	97,851,979	23,934,277	21,560,221	157,518,336	196,484,748	61,757,283	71,674,928	7,215,861	7,795,849
Fixed Income	368,832,970	548,573,814	86,431,022	124,249,131	1,014,521,586	1,478,773,744	329,491,154	477,676,764	33,440,328	51,149,984
Public Equities	817,062,079	881,431,919	226,174,489	248,062,305	2,760,205,444	2,999,507,621	893,335,478	961,709,810	97,675,708	110,380,734
Private Equities	317,985,103	343,613,089	60,481,871	62,498,454	626,125,619	640,198,509	210,733,984	212,362,703	24,597,257	26,899,690
Derivatives	2,529,330	1,241,318	589,964	286,257	7,021,206	3,405,087	2,261,050	1,095,152	267,387	128,419
Absolute Return	216,737,262	266,391,289	53,714,066	59,462,803	640,216,042	705,646,947	202,872,075	223,749,315	23,240,055	26,915,152
Real Return	167,906,666		38,707,259		507,187,432		160,259,285		17,230,917	
Real Estate	101,674,358	113,323,341	30,578,328	31,744,951	335,078,843	348,220,317	107,841,497	112,134,290	13,111,077	13,754,295
Receivables	122,709,423	128,800,955	20,019,287	19,633,081	215,790,631	225,332,529	71,470,289	69,394,346	15,981,523	16,033,918
Payables	(60,545,137)	(58,547,208)	(15,228,581)	(15,482,564)	(162,589,283)	(164,070,941)	(52,857,883)	(52,653,677)	(5,871,561)	(6,094,817)
Total Assets at Fair Value	2,113,018,130	2,324,419,240	525,425,450	552,176,396	6,101,839,655	6,435,054,777	1,987,654,123	2,077,726,348	227,052,958	247,178,549
Change in Assets from Prior Qtr	(211,401,109)	(23,918,072)	(26,750,946)	13,556,203	(333,215,122)	138,896,331	(90,072,224)	51,444,793	(20,125,591)	4,277,827
Net Depreciation/Appreciation	(59,625,921)	(4,791,213)	(17,849,346)	(1,262,603)	(203,113,118)	(7,218,252)	(69,302,393)	(256,416)	(8,502,379)	(1,302,828)
Decline not related to Market	(151,775,188)	(19,126,859)	(8,901,600)	14,818,806	(130,102,004)	146,114,583	(20,769,831)	51,701,209	(11,623,212)	5,580,655

Asset Concentration

	12/31/2015	6/30/2015		12/31/2015	6/30/2015		12/31/2015	6/30/2015		12/31/2015	6/30/2015			
	KERS			KHAZ			CERS			CHAZ			SPRS	
Cash Deposits	0.1%	0.1%		0.0%	0.0%		0.0%	0.0%		0.0%	0.0%		0.1%	0.1%
Short-term Investments	2.6%	4.2%		4.6%	3.9%		2.6%	3.1%		3.1%	3.4%		3.2%	3.2%
Fixed Income	17.5%	23.6%		16.4%	22.5%		16.6%	23.0%		16.6%	23.0%		14.7%	20.7%
Public Equities	38.7%	37.9%		43.0%	44.9%		45.2%	46.6%		44.9%	46.3%		43.0%	44.7%
Private Equities	15.0%	14.8%		11.5%	11.3%		10.3%	9.9%		10.6%	10.2%		10.8%	10.9%
Derivatives	0.1%	0.1%		0.1%	0.1%		0.1%	0.1%		0.1%	0.1%		0.1%	0.1%
Absolute Return	10.3%	11.5%		10.2%	10.8%		10.5%	11.0%		10.2%	10.8%		10.2%	10.9%
Real Return	7.9%	0.0%		7.4%	0.0%		8.3%	0.0%		8.1%	0.0%		7.6%	0.0%
Real Estate	4.8%	4.9%		5.8%	5.7%		5.5%	5.4%		5.4%	5.4%		5.8%	5.6%
	97%	97%		99%	99%		99%	99%		99%	99%		96%	96%

KENTUCKY RETIREMENT SYSTEMS

Cash Flow

Pension Fund

As of December 31, 2015 - 2014

	KERS		KHAZ		CERS		CHAZ		SPRS	
	12/31/2015	12/31/2014	12/31/2015	12/31/2014	12/31/2015	12/31/2014	12/31/2015	12/31/2014	12/31/2015	12/31/2014
INFLOWS										
Member Contributions	\$51,274,912	\$50,376,712	\$7,391,302	\$6,226,671	\$64,003,956	\$61,946,193	\$24,530,529	\$22,895,731	\$2,697,446	\$2,264,272
Employer Contributions	\$260,469,467	\$257,949,755	\$12,827,037	\$11,060,920	\$139,349,146	\$140,454,441	\$54,186,336	\$53,696,274	\$12,934,988	\$13,071,391
Pension Spiking Contributions	\$171,569	\$73,476	\$17,433	\$4,246	\$495,676	\$276,426	\$711,268	\$32,126	\$36,305	\$58,194
Bank of America Settlement		\$8,442,347		\$767,141		\$10,280,391		\$2,865,365		\$644,756
Health Insurance Contributions (HB1)	\$2,350,442	\$2,038,971	\$338,336	\$262,800	\$3,641,361	\$3,072,403	\$695,071	\$471,680	\$57,441	\$45,270
Interest/Dividends	\$13,773,299	\$27,932,972	\$3,819,224	\$5,711,029	\$45,405,476	\$65,975,212	\$14,486,940	\$21,087,360	\$1,593,508	\$2,679,522
Securities Lending Income	\$378,793	\$304,089	\$92,039	\$69,520	\$1,127,003	\$846,799	\$361,336	\$273,025	\$38,516	\$30,480
Total Inflows	\$328,418,482	\$347,118,322	\$24,485,370	\$24,102,327	\$254,022,618	\$282,851,865	\$94,971,481	\$101,321,561	\$17,358,204	\$18,793,886
OUTFLOWS										
Investment Expense	\$7,224,837	\$3,675,111	\$2,080,366	\$1,050,112	\$23,275,921	\$11,999,150	\$7,825,375	\$3,853,748	\$802,959	\$453,219
Securities Lending Borrower Rebates	(\$2,899)	\$51,821	(\$9,438)	\$2,906	(\$116,105)	\$19,022	(\$37,488)	\$8,377	(\$5,107)	\$1,217
Security Lending Agent Fee	\$57,253	\$29,827	\$15,221	\$8,229	\$186,467	\$103,737	\$59,824	\$33,147	\$6,543	\$3,572
Benefit Payments	\$459,125,398	\$450,693,314	\$29,399,832	\$28,110,963	\$321,362,809	\$303,458,372	\$105,494,783	\$98,636,890	\$28,045,937	\$27,279,711
Refunds	\$6,929,404	\$7,648,581	\$1,319,267	\$1,614,974	\$7,493,393	\$7,208,266	\$1,479,705	\$1,450,841	\$7,613	\$52,190
Administrative Expenses	\$7,124,774	\$7,443,793	\$604,488	\$625,564	\$12,373,490	\$12,482,579	\$957,501	\$1,067,837	\$128,891	\$174,353
Capital Project Expenses	\$62,149	\$82,340	\$5,223	\$6,702	\$104,714	\$136,675	\$8,936	\$11,729	\$1,342	\$1,915
Total Outflows	\$480,520,916	\$469,624,786	\$33,414,960	\$31,419,450	\$364,680,689	\$335,407,800	\$115,788,635	\$105,062,567	\$28,988,178	\$27,966,177
Net Cash Flows	(\$152,102,434)	(\$122,506,464)	(\$8,929,589)	(\$7,317,122)	(\$110,658,070)	(\$52,555,935)	(\$20,817,155)	(\$3,741,006)	(\$11,629,974)	(\$9,172,291)

KENTUCKY RETIREMENT SYSTEMS
Cash Flow Projections
Pension Fund

	KERS		KHAZ		CERS		CHAZ		SPRS	
	6/30/2016	6/30/2015	6/30/2016	6/30/2015	6/30/2016	6/30/2015	6/30/2016	6/30/2015	6/30/2016	6/30/2015
	Projected	Actual	Projected	Actual	Projected	Actual	Projected	Actual	Projected	Actual
INFLOWS										
Member Contributions	102,549,824	100,424,471	14,782,604	12,669,450	128,007,912	133,636,499	49,061,058	46,609,087	5,394,892	5,150,288
Employer Contributions	520,938,934	520,948,087	25,654,074	28,373,752	278,698,293	297,715,408	108,372,673	107,513,986	25,869,975	31,443,883
Pension Spiking Contributions	343,139	742,687	34,865	162,137	991,353	850,142	1,422,536	556,690	72,610	545,869
Bank of America Settlement	0	8,442,347	0	767,141	0	10,280,391	0	2,865,365	0	644,756
Health Insurance Contributions (HB1)	4,700,883	4,181,046	676,671	537,228	7,282,723	6,674,325	1,390,143	1,082,700	114,882	94,220
Interest/Dividends	27,546,598	65,596,523	7,638,449	13,897,828	90,810,951	160,823,606	28,973,881	51,237,147	3,187,017	6,379,609
Securities Lending Income	757,585	592,299	184,078	140,054	2,254,005	1,712,510	722,671	550,322	77,031	60,678
Total Inflows	656,836,963	700,927,460	48,970,741	56,547,589	508,045,237	611,692,881	189,942,961	210,415,298	34,716,407	44,319,304
OUTFLOWS										
Investment Expense	14,449,673	16,710,892	4,160,731	4,063,235	46,551,841	44,636,404	15,650,749	14,387,324	1,605,918	1,707,341
Securities Lending Borrower Rebates	(5,798)	40,577	(18,875)	(9,915)	(232,209)	(143,132)	(74,976)	(42,010)	(10,214)	(4,542)
Security Lending Agent Fee	114,506	75,897	30,443	20,640	372,934	256,776	119,647	82,095	13,086	8,993
Benefit Payments	918,250,795	905,790,711	58,799,664	56,773,173	642,725,617	615,334,770	210,989,567	200,133,703	56,091,873	54,765,255
Refunds	13,858,809	13,552,144	2,638,534	2,609,464	14,986,786	13,523,666	2,959,410	3,110,537	15,225	85,000
Administrative Expenses	14,249,547	10,473,878	1,208,977	844,208	24,746,981	18,212,642	1,915,003	1,287,827	257,783	201,108
Capital Project Expenses	124,299		10,446		209,428		17,872		2,684	
Total Outflows	961,041,832	946,644,100	66,829,919	64,300,804	729,361,378	691,821,126	231,577,271	218,959,477	57,976,356	56,763,155
Net Cash Flows	(304,204,869)	(245,716,640)	(17,859,179)	(7,753,216)	(221,316,141)	(80,128,245)	(41,634,310)	(8,544,179)	(23,259,948)	(12,443,851)



KENTUCKY RETIREMENT SYSTEMS INVESTMENTS



TO: Kentucky Retirement System Board of Trustees

FROM: David Peden, Chief Investment Officer

DATE: February 18, 2016

SUBJECT: Investment Committee Quarterly Report

The Investment Committee held its regularly scheduled meeting on February 2, 2016. The purpose of the meeting was to evaluate investment activities, program structure, management, controls, and performance results of the Pension and Insurance Funds, for the quarter ending December 31, 2015, along with various other subjects.

The meeting began with approval of the minutes for the previous Investment Committee meeting held on November 4, 2015.

Erica Bradley, Compliance Officer, presented the Quarterly Compliance Report. It was noted that the asset allocations were in a state of transition in the month of December 2015 as the investment team moved assets to the January 1, 2016 asset allocation.

The Management Update was given by David Peden, CIO, which included a review of some of the standard quarterly reports. These reports included the: Monthly Performance Update, Investment Division Budget Report, the quarterly Manager Meeting and Related Expense Tracking Report, the Internally Managed Portfolio Asset Report, Internally Managed Portfolio Transactions Report, Securities Lending Report, Domestic Equity Commissions Report, Global Equity Commissions Report, and the Securities Litigation Report were provided for informational purposes.

The Standing Quarterly Committee Topics, Potential Future Topics List, and an overview of the supplied articles of interest were reviewed. Questions were encouraged and addressed throughout the reports.

KRS Investment Staff, Prisma Capital Partners, and consultant Albourne recommended an initial investment of approximately \$20 million to DSAM+ and an initial \$35 million each to DB LiquidAlts H2O Force 10 and Myriad Asset Management. This recommendation was approved by the KRS Investment Committee. All five pension systems and all five insurance systems will participate in this investment. The investment managers in the marketing and due diligence process used no placement agents.

Prisma Capital Partners gave a review of the trial period of the strategic partnership between KRS and Prisma. KRS Staff also gave a review of this relationship and recommended the KRS Investment Committee continue the relationship on an official basis. This recommendation was approved by the Investment Committee. KRS Staff also recommended unwinding the fund of hedge funds managed by Blackstone and this recommendation was approved by the Investment Committee.

KRS Investment Staff and consultant ORG recommended an initial investment of approximately 50 million EURO to Patron Capital V, L.P. All five pension systems and all five insurance systems would receive allocations to this investment. The investment managers in the marketing and due diligence process used no placement agents. No action was taken on the recommendation and the investment was referred by the Investment Committee to full Board for consideration.

KRS Investment Staff and consultant PCA recommended a commitment of \$50 million to Green Equity Partners VII, L.P. Pension systems KERS Hazardous, CERS, and CERS Hazardous and all five insurance systems will participate in this investment. The investment managers in the marketing and due diligence process used no placement agents. This investment recommendation was approved by the investment committee.

KRS Investment Staff and consultant PCA recommended a commitment of \$50 million to Vista Equity Partners VI, L.P. Pension systems KERS Hazardous, CERS, and CERS Hazardous and all five insurance systems will participate in this investment. The investment managers in the marketing and due diligence process used no placement agents. This investment recommendation was approved by the investment committee.

Staff and Consultant RV Kuhns presented a recommendation for a new U.S. equity core position as the investment team moves to a core/satellite structure from a style box structure. The newly recommended core position is the Scientific Beta U.S. Multi-Beta Diversified Multi-Strategy Index and will replace the existing internally managed S&P 500 portfolio. The new strategy will also be internally managed by staff and is not an external money manager. The conversion from the S&P 500 to the Scientific Beta strategy will be in stages and the speed of conversion will be dictated by U.S. equity market conditions. This new strategy was approved by the investment committee.

Erica Bradley, Compliance Officer, presented the results of an Internal Performance Audit and a separate Internal Financial Review. This was for information purposes only and no action was taken.

Karen Roggenkamp, COO, and Ann Case, Deputy Controller, presented reporting on investment fees and expenses. Ann also reported a financial trend and cash flow analysis. This was for informational purposes only and no action was taken.

Please see the next page for a summary of the Pension and Insurance performance information ending December 31, 2015.

Pension Funds Performance Overview Rates of Return (%) as of December 31, 2015								
	One Year		Three Years		Five Years		Ten Years	
	Fund	Index	Fund	Index	Fund	Index	Fund	Index
Equity	-2.94	-3.48	7.38	7.03	5.88	5.97	4.84	4.59
Fixed Income	0.50	0.43	1.94	1.51	4.49	3.60	4.85	4.63
Private Equity	11.15	11.15	14.13	14.13	13.44	14.26	8.55	9.69
Real Estate	8.89	13.86	8.97	12.39	10.07	12.95	6.01	5.73
Absolute Return	1.70	0.83	6.12	4.67	5.84	2.90	N/A	
Real Return	-5.96	-4.10	-2.45	0.34	N/A		N/A	
Cash Equivalents	0.21	0.03	0.34	0.04	0.32	0.05	1.75	1.17
Total Fund	-0.02	0.64	5.81	6.54	5.84	6.29	5.17	5.51

Insurance Funds Performance Overview Rates of Return (%) as of December 31, 2015								
	One Year		Three Years		Five Years		Ten Years	
	Fund	Index	Fund	Index	Fund	Index	Fund	Index
Equity	-2.81	-3.36	7.47	6.95	5.76	5.99	4.57	4.36
Fixed Income	0.53	0.43	1.32	1.51	4.20	3.96	4.87	4.64
Private Equity	15.92	15.92	16.59	16.59	14.74	14.32	9.16	9.04
Real Estate	8.99	13.86	8.43	12.39	10.05	12.95	N/A	
Absolute Return	1.80	0.83	6.11	4.67	5.86	2.90	N/A	
Real Return	-6.13	-3.69	-2.52	0.53	N/A		N/A	
Cash Equivalents	0.21	0.03	0.22	0.04	0.28	0.05	1.55	1.17
Total Fund	-0.12	1.28	5.42	6.79	5.16	6.54	4.41	5.05

RECOMMENDATION: The Board is requested to ratify the actions of the Investment Committee.



Real Estate Recommendation

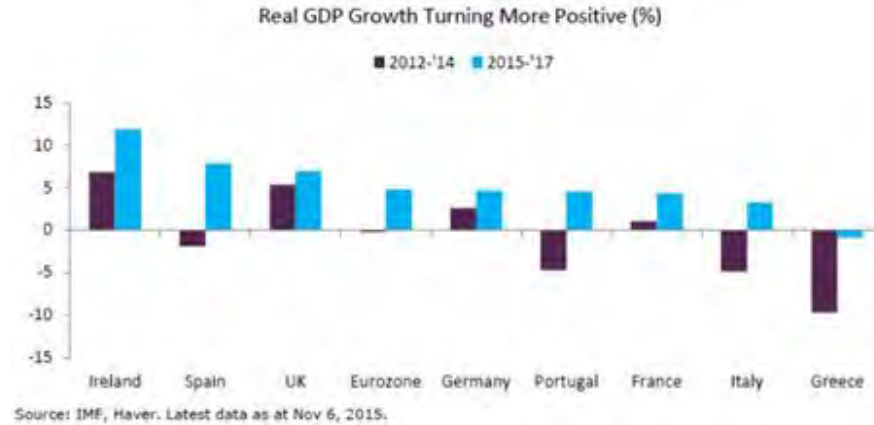
European Real Estate

. . .from Idea to Investment

The Due Diligence Process

Investment idea or thesis is identified . . .

Europe's fiscal deficits have been largely corrected . . .



Euro Area Unemployment Rate

As the ECB eases, Euro denominated assets will be attractive . . .





STEP 1

Build a case against or confirm the opportunity to research

- ✓ **Why European Real Estate?**
- ✓ **Macro considerations**
 - Economy, Geo-political, Industry data
- ✓ **Historical information – Timing, Potential Returns, etc.**
 - Asset class returns, correlations, risk factors
- ✓ **Engage asset class consultant to research thesis**
 - Industry search activity, are other plans looking?



Thesis confirmed as viable opportunity...



STEP 2

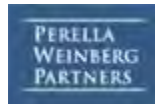
Work with consultant to identify list of potential partners/managers for investment



- ✓ ORG database / KRS direct contacts and meetings
- ✓ Identify and evaluate both Quantitative and Qualitative factors
 - Capacity (accepting new \$?), Longevity, Reputation, Size – AUM, Principals, etc.



Blackstone



BLACKROCK

STEP 3

Start a file for each potential partner – Intro calls

- ✓ Gather information – Fund books, websites, press releases, etc.
- ✓ Research past Funds/Investments and firm data – ACRES system
- ✓ Schedule introductory calls or update calls with KRS & ORG staff
 - Confirm conviction of thesis – validate or contradict
 - Pose consistent series of questions to identify similarities/differences
 - Seek to identify issues that may eliminate from consideration – departures, legal, etc.
- ✓ Ask managers to begin flow of information to KRS
 - Transactions, news, white papers, industry info, country/region
 - Pose consistent series of questions to identify similarities/differences



First eliminations* made, potential partners advance...

*** "Key-man" risk, Information flow, ORG issues, Reputational risk", etc**

STEP 4

Schedule in-person meetings – KRS and/or ORG

- ✓ **Key related professionals – not just marketing**
- ✓ **Conduct in-depth discussions about proposed mandate**
 - Macro, Regional, Geo-political
- ✓ **Confirm conviction of thesis**
- ✓ **Conduct in-depth discussions about firm**
 - Firm, team, systems, process, experience, history, character, etc.
- ✓ **Schedule or accept requests for additional meetings**
 - Conduct "on-site" manager reviews, either KRS or ORG staff

STEP 5

Reduce list to "Finalists" – Conduct presentations

- ✓ **Request written response to specific "Key Issues"**
- ✓ **Conduct final presentations with both KRS and ORG staff**
- ✓ **Open discussion construct**
 - Random, mandate-related topics initiated
 - Recent news, industry information, asset class developments
 - Confirmation of all information gathered in process – opportunity to add or amend



STEP 6

KRS and ORG conduct thorough review of FINALISTS

- ✓ All information is up for review – Quantitative and Qualitative
- ✓ Extensive discussion and debate – no “ownership” – why? why not?
- ✓ Verification of all relevant facts and new developments, if any
- ✓ Selection of manager for mandate



Patron Capital selected as manager of European Real Estate mandate

- ✓ Manager notified of selection – pending board approval
- ✓ Confirmation of capacity, closing dates, fund terms
- ✓ Preparation begins for Board presentation



PATRON
CAPITAL PARTNERS



IPE Real Estate Top 100 Investment Management Survey

NOVEMBER/DECEMBER 2015 (MAGAZINE)

The Top 100 Investment Management Survey provides a snapshot of an evolving global industry. The table below shows the largest 100 real estate managers by assets under management.

#	Company	Total RE AUM 30/06/15 (€m)
52	Patron Capital	10,478

Opportunistic – Global

	Company	€m
1	Brookfield AM	59,770
2	Starwood Capital Group	26,028
3	Hines	22,813
4	Morgan Stanley Real Estate	13,050
5	Patron Capital	10,478
6	Walton Street Capital	7,731
7	BlackRock	7,588
8	Oaktree Capital Mngt.	6,301
9	Gaw Capital Partners	6,183
10	CBRE Global Inv.	5,800

Opportunistic – Europe

	Company	€m
1	Patron Capital	10,478
2	Starwood Capital Group	6,202
3	Hines	5,946
4	Morgan Stanley Real Estate	5,114
5	BMO Real Estate Partners	2,156
6	Aberdeen AM	1,866
7	Savills IM	1,231
8	AEW North America & Asia	1,102
9	Brookfield AM	1,059
10	Legal & General Property	1,048

Patron Capital Wins Professional Pensions' UK & European Opportunistic Property Manager of the Year

Patron Capital, the pan-European institutional investor focused on property-backed investments, has won the UK & European Opportunistic Property Manager of the Year category of the Investment Awards 2015, organised by the respected pension industry publication, Professional Pensions.



Patron buys The Mint office in Leeds

7 May 2015 | By Guy Montague-Jones



CHINESE BURN Keith Breslauer

What's happening in China and how might it affect European property markets?

Property Week
30 October 2015



Patron Capital V, L.P.

Kentucky
Retirement Systems

February 2016



Executive Overview

- **Established European manager led by founder and Managing Director Keith M. Breslauer**
 - Operations across Europe with advisory offices in the UK and Luxembourg and offices in Germany, Spain and Italy
 - Experienced 73-person team including 41 investment professionals with regional and product focused expertise
 - Owner operator model with low team turnover (<4%) since inception
- **Since 1999, Patron has invested in 61 investments totalling €2.2 billion of equity and over €9 billion of gross asset value predominantly across Western Europe**
 - Patron's Western Europe investments are projected to generate a 21% gross IRR and 1.75x gross equity multiple on €1.9 billion of equity (85% of total invested equity) ⁽²⁾
 - Patron's total investments across Europe are projected to generate a 16% gross IRR and a 1.60x gross equity multiple, utilizing conservative leverage of approximately 41% loan to value ("LTV") ⁽²⁾
- **Patron Capital, V L.P. (the "Fund" or "Fund V")**
 - €750 million fund targeting opportunistic and value-oriented investments in property and property-related assets, loans and corporate entities, predominantly in Western Europe
 - Successor vehicle to €780 million Patron Capital, L.P. IV ("Fund IV") with €330 million of additional co-investment capital
 - 17% - 22% targeted gross leveraged IRR with 1.7x+ gross equity multiple ⁽¹⁾
 - €577m committed/approved to date (€562m closed) with expected additional closings in coming month. An additional €75m of co-investment pools committed, bringing total capital to €652m.
 - Fund V Capital comprises over 80% from existing investors and over 92% from investors who have known Patron for over 5 years.









(1) The target return is neither a guarantee nor a projection of future performance. Gross IRR and gross returns do not reflect the effect of General Partner's share, carried interest and other expenses
(2) Please see Endnotes to Investment Performance in Appendix IV for further information. Past performance is not indicative or guarantee of future results

Patron Platform – Integrated and Interactive (41)







- Dedicated 73-person team including 41 investment professionals averaging 18 years of experience and senior partners averaging 23 years of experience

Keith M. Breslauer




Country Focus

 Christoph Ignaczak
 Pedro Barcelo
 Georg von Hammerstein*
 Vicente Conesa*
 Mark Collins
 Daniel Weisz
 Luigi Capuano
 Bertrand Schwab*
 Matt Utting
 Jason Meads*
 Robert Booth*
 Guillaume Lefort*

Shane Law

 Laurens Feleus
 Michael Capaccio
 Rafael Fitoussi
 Wiktor Lesinski
 Yolanda Leal
 Juan Du
 Jonatas Szkurnik
 Simon Geldmann
 Arnau Osorio
 Paul Nearchou
 Julian Rosenberg
 Giovanni Bimbi
 Angela Favullo

Product Focus


 Stephen Green
 Andrew Cummins
 Irina Stamate-Rocha
 Tim Street*
 Danny Kay*
 Camil Yazbeck
 Josh Wyatt*
 Ashish Kashyap
 Nate Kornfeld*

Development
Kevin Cooke


Jason Gunn Thijs Van Dorssen Richard Sykes




Chart Key


* Senior Advisers

 European Generalist

 Corporate

 Hotels & Leisure

 Home Building
 Petrol Stations
 Forecourts

 Residential & Consumer Distressed

 Commercial Credit & Distressed

 Development

 Healthcare

2011 vs 2016: Strong Relative Investment Period for Western Europe

Context	2011-2015 Fund IV	2015-2018 Fund V	Opportunity?
Macroeconomic Environment	Economy across Europe highly uncertain and clear risk of Euro breakup in investors' minds	More stable and improving economic environment; improvement of liquidity, falling commodity prices and weaker Euro (factors not present in earlier period) are bolstering growth	Much better, with less uncertainty but a recovery subject to macro geopolitical risk Buy/Exit Good/Tricky
Regulatory Environment	Uncertain, lots of discussion and planning, with limited incentives for asset resolution	Significant changes in environment with a series of stress tests that are pressurising banks for sales; combined with re-emergence of non bank lenders increasing Regulatory Capital requirements as suppliers of liquidity	Supportive , although still limited transparency Buy Great
Debt	No, to very limited lending availability	Debt has returned in prime markets and for prime assets. Levels still significantly less than what they were in the boom; non-bank lenders becoming more active in the UK	Helpful, improving ROI , more liquidity Buy Exit OK Great
Available Inventory from Deleveraging	Limited, few banks selling, bad banks just really forming	Significant, various bad banks now created and active in disposition with UK/Ireland leading in past 12 months and Spain/Portugal, Ireland and Germany next	Massive, but tricky given large volume of weak product Buy Great
Breakup Opportunities from Large NPL Sales	Barely started	The multi-billion Euro sales of loan portfolios by Lloyds, NAMA, Sareb and others in the last couple of years will generate a steady stream of smaller granular opportunities as the portfolios are liquidated	Granular opportunities available for a niche player Buy Good
General Supply Across Classes	Significant excess supply across all classes; very limited if any new supply, except residential which was beginning in key cities	Limited new supply in most classes and locations, with a lack of new development since the GFC and increasing pressure on rents	Significant ; more visibility on improvement potential of distressed assets Buy Great
Demand Across Classes	Strong demand for yielding assets and interest in property classes that either meet the annuity liability requirements or havens of capital safety; SWFs emerging as important capital players on cross market basis	Continued increase in interest for yielding assets from massive yield hungry investors; global capital flows increased significantly with continued ramp up of SWF interest in “trophy” assets	Better exit opportunities for prime yielding assets Buy Exit Tricky Great

Conclusions - Macro Europe & Markets

- The European economy continues to gradually strengthen. This is facilitated by strong liquidity and low level of oil price – **Major Positive**
- Continuous growth of capital values is supported by the shortage in new supply, falling vacancy rates and rising rental level – **Major Positive**
- Increasing capital inflows into Europe create liquidity as investors are hunting for yield, gradually migrating to regional/more risky assets – **Major Positive (exit)**
- Fragmented markets with limited transparency provide granular players, like Patron with unique profitable opportunities – **Major Positive**
- The general low growth economic environment makes investing tricky, as certain assets will not have long term value – **Be Careful!**

Deep Value Investment Strategy

Focus on Investments below Intrinsic Value

		Target %
Distressed	Assets/Portfolios <ul style="list-style-type: none"> • Bank driven sales/liquidations • Liquidity constrained operators/borrowers/developers 	50-60%+
	Businesses with Underlying Property below Intrinsic Asset Value: <ul style="list-style-type: none"> • Stable cash flow generative companies supported by property assets • Asset break-up and sale with subsequent entity exit or shut-down 	40-50%+
Institutional Non-Core (ex distressed)		
	<ul style="list-style-type: none"> • Property assets below intrinsic value deemed non-core by parent/owner 	0-10%
Complex Situations		
	<ul style="list-style-type: none"> • Attractive property encumbered by complex situations 	0-5%

Patron Capital Strategic Focus

- **Cheap underlying basis**, relative to comps and historical
- **Shorter duration**, < 5 years, ideally < 4 years
- **Cash generative, no long term, large development with planning risk**
- **Good local partners**, especially with more complex plans
- **Generally smaller investments**, < €100m equity, limited competition
- **Owner-operator hybrid model**, strong oversight, typically active partners
- **Regional focus**, regions with greater historical liquidity (WE)

Investment Performance – Overall

- Since inception in 1999, Patron has invested in 61 investments representing €2.2 billion of equity and over €9 billion of gross asset value
 - Approximately €1.9 billion of this €2.2 billion has been deployed in Western Europe and is projected to generate an **aggregate gross IRR of 21% and a gross equity multiple of 1.75x**
 - Low leverage of approx. 41% LTV utilised across all funds and co-investment pools

Patron Overall Performance as of September 30, 2015 (€ in millions) ⁽¹⁾
(Past 15 years)

	<i>Number of Investments</i>	<i>Invested & Identified Equity ⁽ⁱⁱ⁾</i>	<i>Realised Proceeds ⁽ⁱⁱⁱ⁾</i>	<i>Unrealised Proceeds ^(iv)</i>	<i>Total Realised & Unrealised Proceeds ^(v)</i>	<i>LTV ^(vi)</i>	<i>Gross IRR ^(vii)</i>	<i>Gross Equity Multiple ^(viii)</i>
Overall Patron Performance	61	€ 2,195	€ 1,264	€ 2,250	€ 3,514	40.7%	16%	1.60x
Western Europe	53	€ 1,876	€ 1,230	€ 2,054	€ 3,284	38.3%	21%	1.75x
Cash Generative	40	€ 1,598	€ 1,034	€ 1,972	€ 3,006	37.4%	24%	1.88x
Western Europe & Cash Generative	37	€ 1,585	€ 1,297	€ 1,677	€ 2,974	37.4%	24%	1.88x

(1) Please see Endnotes to Investment Performance in Appendix IV for further information.

Fund V Investments (since Nov 15)

Fund V investments (since Nov 15)

#	Investment Name	Country	Type	Base Case			Target Case		
				Equity (€m)	Projected EM	Projected IRR	Equity (€m)	Projected EM	Projected IRR
Closed Investments									
1	Cologne	Germany	Office	9.2	1.62x	16.1%	9.2	1.80x	21.8%
2	La Cordee	France	Resi	14.6	1.50x	28.6%	8.3	1.92x	54.7%
3	Eastpoint ⁽ⁱⁱ⁾	Ireland	Office	16.3	1.76x	17.2%	16.3	1.89x	21.7%
4	Green ⁽ⁱⁱ⁾	Spain	Retail	17	1.60x	17.0%	17	1.70x	20.0%
Subtotal				57.1	1.62x	19.9%	50.8	1.83x	29.6%
Subject to Final Approvals & Formal Completion									
5	Aqua ⁽ⁱⁱ⁾	Spain	Mixed Use	33.9	1.70x	15.0%	26.0	2.31x	25.4%
6	Turbo ⁽ⁱⁱ⁾	UK	Residential (Mid-Market)	60.6	1.67x	17.0%	60.6	1.92x	20.7%
Subtotal				94.5	1.68x	16.3%	86.6	2.06x	22.4%
Allocated but not yet Committed									
7	Habitat ⁽ⁱ⁾	Portugal	Resi	18.9	1.47x	18.1%	12.6	1.77x	39.5%
Total				170.5	1.64x	17.7%	150.0	1.95x	26.7%

i) Completed on Largo do Mastro for €3.5m (the first property). Proposed larger program yet to be formally approved.

ii) Completion expected Q1/Q2 2016, either due to the Fund waiting for regulatory proposals or closing terms to be finalised

Note - for the purpose of calculating a weighted average return, the projected returns and approved € amount per the Investment Committee Memoranda are used. No FX impact is assumed on the returns of non-EUR deals (UK)

Cologne, Germany (Fund V)

Location:	Germany	Acquisition Date:	December 2015
Invested Equity:	€9.2 million	Investment Status:	Unrealised
Industry:	Office	Deal Type:	Asset below intrinsic value / Non-Core
Gross IRR:	16%	Gross Multiple	1.6x

- Acquisition of a 14,372 sqm office building on the border of Cologne's city centre, with significant and unique redevelopment potential in an economically strong and affluent city with a good micro location and excellent connections to public transportation
- JV partner is Development Partner AG, an experienced office and retail developer and investor with a strong track record. Development Partner AG is investing 20% of total equity
- Seller is Patrizia who has shifted strategy from a direct investor to primarily a Spezialfonds manager. As a result the asset has become non-core for them
- Asset is currently 52% let, generating rental income of approx. €756,000 p.a. reflecting a €12.80 psqm rent with a WALT of 2.2 years



Strategy, Value Added and Results:

- Plan is to reposition the asset as a landmark building within the premium segment which is undersupplied in the local market
- Termination of all existing leases until 31/12/2016, implement extensive capex program (€1,775 psqm) - the property will be stripped out and completely refurbished (incl. upgrade of the façade) into a high end, functional and flexible office space, comprising 14,372 sqm of lettable area
- Lease up of refurbished office space at an average ERV of €15.50 psqm
- Exit to investor market at a 5.4% cap rate (€3,939 psqm)

Projected gross IRR of 16% and a gross equity multiple of 1.6x

Key Value Drivers

- Repositioning of undervalued real estate asset through active asset management and implementation of accretive capital expenditure program and sell to core investors seeking yield
- Asset acquired for 4.6% yield (48% vacancy), improve to stabilised yield of 7.0% and exit at 5.4% yield

East Point, Ireland (Fund V)

Location:	Ireland	Acquisition Date:	Exchanged December 2015, completion May 2016
Invested Equity:	€12 million – up to €16 million (capex)	Investment Status:	Unrealised
Industry:	Office	Deal Type:	Assets below intrinsic value
Gross IRR:	17%	Gross Multiple	1.8x

Transaction Summary:

- Acquisition of four multi-let office buildings with gross internal area of 153,000 square feet at East Point Business Park, Dublin
- The assets are let to 6 tenants (including Oracle, Google and Verizon) and at underwriting were 12% vacant by floor area (7% vacant subject to new letting in progress, agreed in December 2015, completes)
- The rent being paid by each tenant varies from €5 psqft to €15 psqft (average €9 psqft), driven by when individual leases were agreed –Current lettings on the park (and acquired assets) are achieving €22 psqft
- The Assets are being acquired in joint venture with Earlsfort and O'Callaghan Properties, Patron's local partner on Northside Shopping Centre (Project Drive) – Earlsfort (original developer of the park and current asset manager across various buildings) will asset manage the assets and O'Callaghan will act as our investment partner.



Strategy, Value Added and Results:

- Lease-up, re-let and re-gear of existing leases supported by significant €7.7m capex and tenant improvement program across the assets
 - Lease up of current 12% vacant space
 - Re-let of 28% of assets (upside is re-gear to current tenant as position unclear)
 - Re-gear of 34% of assets (primarily one tenant with significant presence on park)
- Exit as a portfolio sale in 4 years - while the Assets can be sold individually, it is expected that purchasers will find it an attractive opportunity to buy a portfolio of assets at East Point.

Projected gross IRR of 17% and a gross equity multiple of 1.8x

Key Value Drivers

- Asset acquired for 4.4% yield (12% vacancy but significantly under-rented to ERV), improve to stabilised yield of 9.8% and exit at 6.0% yield (6.6% on ERV)

La Cordee, France (Fund V)

Location:	Chamonix, France	Acquisition Date:	December 2015
Invested Equity:	€14.6 million ⁽¹⁾	Investment Status:	Unrealised
Industry:	Residential	Deal Type:	Assets below intrinsic value / Non-Core
Gross IRR:	29%	Gross Multiple	1.5x

Transaction Summary:

- Acquisition of c. 7,000 sqm of existing residential asset blocks in Chamonix (France) to refurbish and resell individually. The Asset is located in the heart of Les Praz, the most prime residential area within the Chamonix Valley.
- The Asset is made of 8 contiguous buildings (124 apartments mostly one bedrooms) with floor levels ranging from two to four stories and generates more than 6,919 sqm of space over a total land surface of 1.8 hectares. There are 144 parking spaces of which 124 underground spread over one level of 3,023 sqm.
- The asset was sold and operated by Hapimag a Swiss time-share apartment's owner-operator which decided to sell it because it was considered non-core to its global strategy for a total consideration including acquisition costs of €21.5m which represents a cost per sellable sqm of €3,632.

Strategy, Value Added and Results:

- Partnering with Cardea Real Estate Investment a Chamonix based local developer specialised in opportunistic origination, management and development of high margin residential real estate projects in Chamonix
- Execute a light refurbishment for €11.1m (€1,871 psqm) over 18 months to reposition the Asset as a 69 apartment medium / high-end condominium complex
- Leverage on the particularly low acquisition price to offer an aggressive price of €8,250 psqm upon sale (representing a 13.1% discount vs. direct competition (€9,436 psqm) and overall Les Praz current apartment ask price)
- With a combination of strong pricing and controlled marketing process to sell a minimum of 2.2 units per month and c. 26 units p.a. on average

Projected gross IRR of 29% and a gross equity multiple of 1.5x

(1) Including equity allocated for refurbishment work

Chamonix, France	Les Praz, Chamonix
	
Outside Pictures of the Asset	
	
Key Value Drivers <ul style="list-style-type: none"> Refurbishment of existing asset to exit in retail market Very low entry (€3,632 psqm) enabling aggressive pricing (€8,250 psqm 13% below market) with project still generating gross margin above 31% 	

How Patron Helps to Change the World



Supports current or retired members of the British Armed Forces who continue to defend freedom & our way of life, and who are facing difficulties as a result of their service.

- Patron has raised in excess of £700,000 (>\$1 million) for the Royal Marines Charitable Trust Fund over the past few years
- Patron team participated in various important fundraising sport events including:
 - RM 1664 Challenge:
 - Kayak (26 hour/120 mile kayak across the English Channel)
 - 30 mile night time run
 - Multiple sponsored climbing/running & athletic challenges (i.e. Half Marathons every year)
- Complimentary respite breaks at our Patron portfolio hotels given to over 20 servicemen & their families and these continue to be available to service personnel who are ill or recovering from injuries
- Improving career & business prospects through facilitating, mentoring, internships & training programs in UK industries
- Multiple individuals in recovery have been guests on Patron's annual ski trip for the last four years



Supports educators & funds projects to improve education with refurbishment and construction of new schools, harnessing their multiplier effects in key areas of society.

- Patron has provided support to a team which help build and refurbish schools in the valleys leading to Everest:
 - Thame School, Pangboche Village School, Sedowa Village School, Lukla Village School, Gola School, Karmarang School and Ligam School
- Patron is a senior patron of The Prince's Teaching Institute (PTI), which has dramatically helped over 540,000 kids across England over the past 5 years, through supporting continuing education primarily for state school teachers
- Patron team participated in various athletic events to raise significant monies for the PTI and the Nepalese initiative
- Patron supports the Social Enterprise Initiative at the University of Chicago Booth School of Business which brings together researchers to tackle societal issues and considers how institutions help solve social problems
 - Various scholarships have been provided to students and their respective teams to help support their businesses



Empowers & supports the building blocks of society through improving & preserving the physical environment, providing emergency aid and ongoing support for the vulnerable.

- Patron is a main supporter of The Prince's Regeneration Trust, a world leading charity in the heritage regeneration sector which has managed over 70 regeneration projects, attracting over £150m investment & regenerating more than 1.3m square feet of redundant floor space
- Significant donations have been made to various organisations to support their work providing:
 - Immediate aid to those impacted by war on terror
 - Improvement to the lives of vulnerable children and adults with learning disabilities
 - Residential accommodation for the elderly & disabled
 - Powerful positive experiences for children with cancer
- Supporting Seppi Enzo and the Guide team providing critical infrastructure for water, power and community building refurbishment in many Everest Valley villages
- Various senior Patron partners have participated in important sporting events and raised significant sums including running a marathon in the Antarctic and a 2nd marathon through Sierra Leone which contributed to Street Child's work with out-of-school children across West Africa and cycling from London to Paris for a national spinal charity

Real Estate International Investing and Pacing Plan



Kentucky Retirement Systems
February 18, 2016

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About ORG



Who We Are - Mission Statement

ORG is a **real assets investment consultant** providing clients with customized, objective advice. Our investment recommendations and analysis are grounded on **thoughtful and conservative underwriting and comprehensive research** delivered with conviction. We provide clients with unequalled access and transparency to global investment opportunities.

ORG Overview

ORG Portfolio Management, LLC:

is a Registered Investment Adviser under the Investment Advisers Act of 1940, as amended, and began providing institutional real estate consulting services in 1999 from its Cleveland, Ohio headquarters.

Exclusively focused on:

providing real estate and real asset consulting services for institutional investors and private portfolios through commingled funds and separate accounts.

Stable, knowledgeable staff with investment expertise gained through prior experiences:

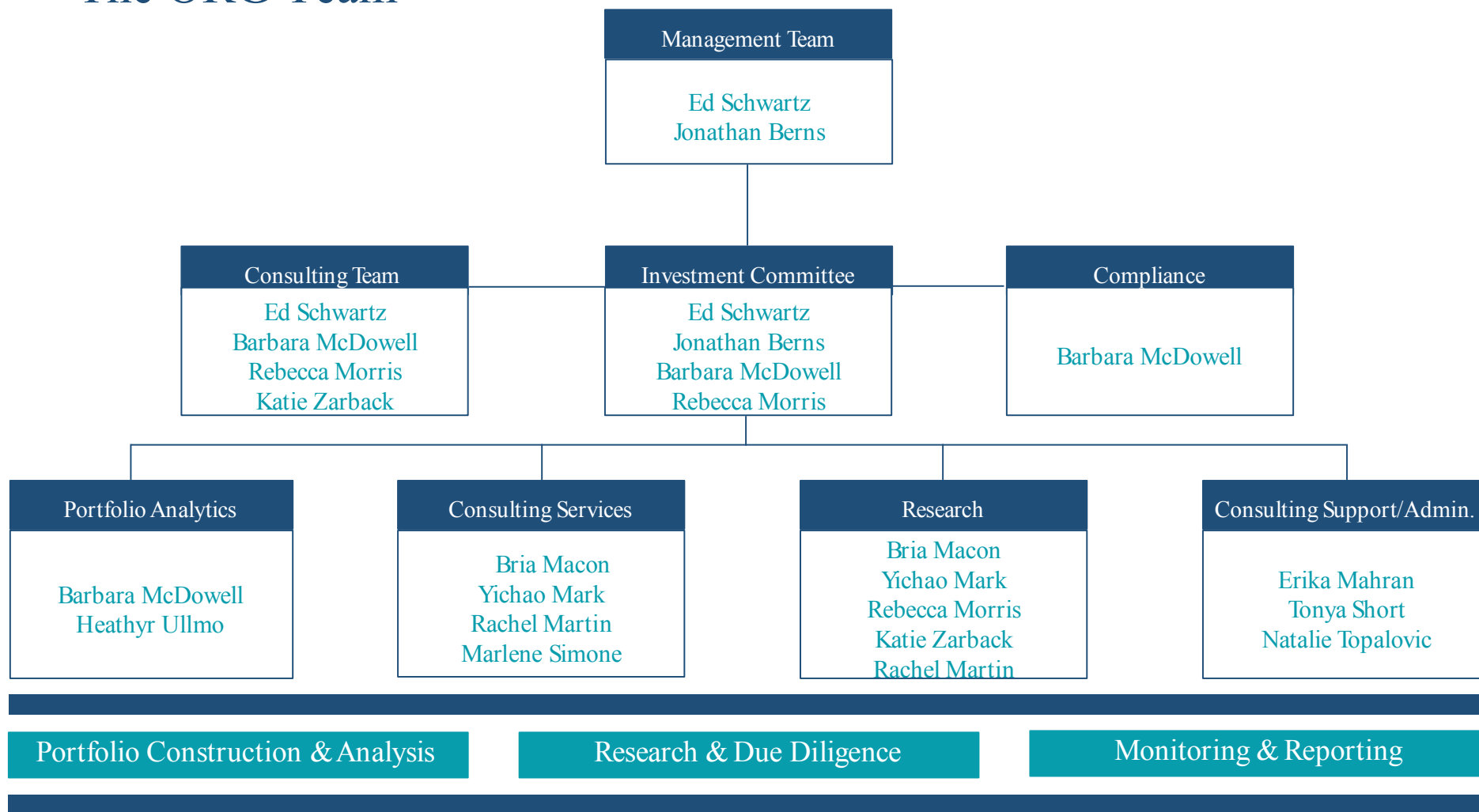
Commercial property ownership, acquisition, development, and property management.

Portfolio strategy and research.

Plan sponsor head of real estate.

Talented, diverse team supports ORG's mission and provides the best in class client services.

The ORG Team



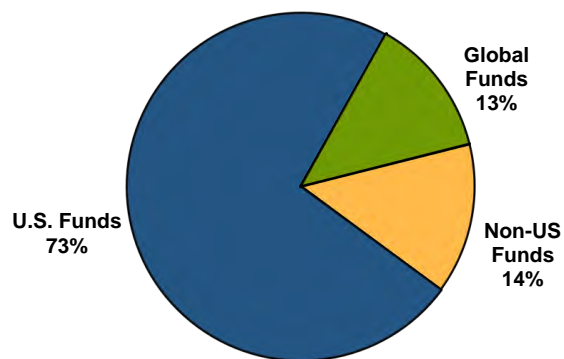
International Investing



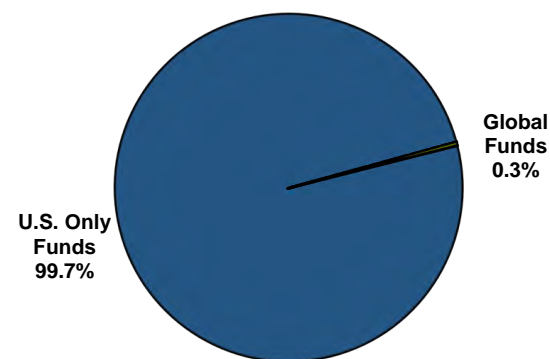
ORG Clients with Non U. S. Investments

- ORG clients have over \$500 million commitments to Non U.S. real estate funds plus an additional \$500 million commitments to global real estate funds.
- KRS has \$70 million commitments to global real estate funds.
- A 2016 Pension Real Estate Association Study (“PREA”) shows that North American investors (including Canada) have large allocations to Non U.S. investments.

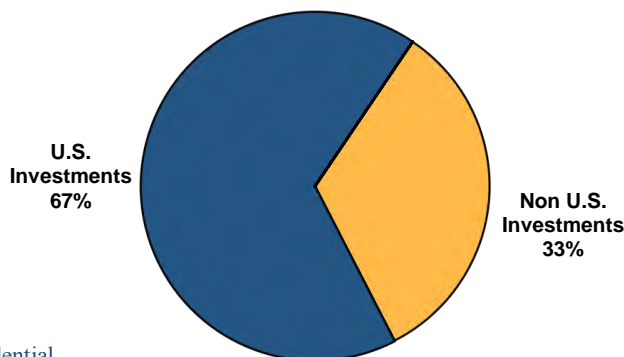
**Percent Total Commitments
All ORG Clients**



**Market Value as of 9/30/2015
KRS Only**



PREA Study



Global Investments in Funds:
Divco West IV – Includes Europe
Walton St. VI – Includes India and Mexico



KRS 2016 Pacing Plan



2016 KRS Pacing Plan

- Pacing Plan for 2016 includes:
 - The projected return of capital of \$226.8 million includes the current KRS redemption requests from open end funds – Harrison Street, H/2 Capital, Prima.
 - New commitments of \$150.0 million per year should allow KRS to move towards its target allocation.
- Target allocation of 5% is approximately \$800 million for 2016 which should change over time as the total market value of the fund changes.

	KRS Real Estate Profile Projected Activity by Year				
(\$ Millions)	2016	2017	2018	2019	2020
Beginning Real Estate Market Value	\$843.9	\$732.1	\$819.5	\$951.8	\$1,078.4
<i>Projected Commitments During Period</i>	<i>\$150.0</i>	<i>\$150.0</i>	<i>\$150.0</i>	<i>\$150.0</i>	<i>\$150.0</i>
Projected Invested During Period	\$107.0	\$102.0	\$145.0	\$137.5	\$130.0
Projected Return of Capital	(\$226.8)	(\$22.5)	(\$21.5)	(\$21.0)	(\$22.0)
Annual Appreciation Estimate	\$8.0	\$7.9	\$8.8	\$10.1	\$11.4
Projected Ending Real Estate Market Value	\$732.1	\$819.5	\$951.8	\$1,078.4	\$1,197.8

Appendix



KRS Real Estate Portfolio Financial Highlights

Financial Highlights At September 30, 2015	Market Value	Percent of Fund
Portfolio Market Value	\$855,575,117	5.8%
Current Unfunded Commitments	\$101,427,345	
Total Market Value and Unfunded Commitments	\$957,002,462	6.5%
Total Fund Market Value	\$14,793,254,013	
Total Allocation to Real Estate	\$739,662,701	5.0%
Total Loan-to-Value Ratio	46.0%	

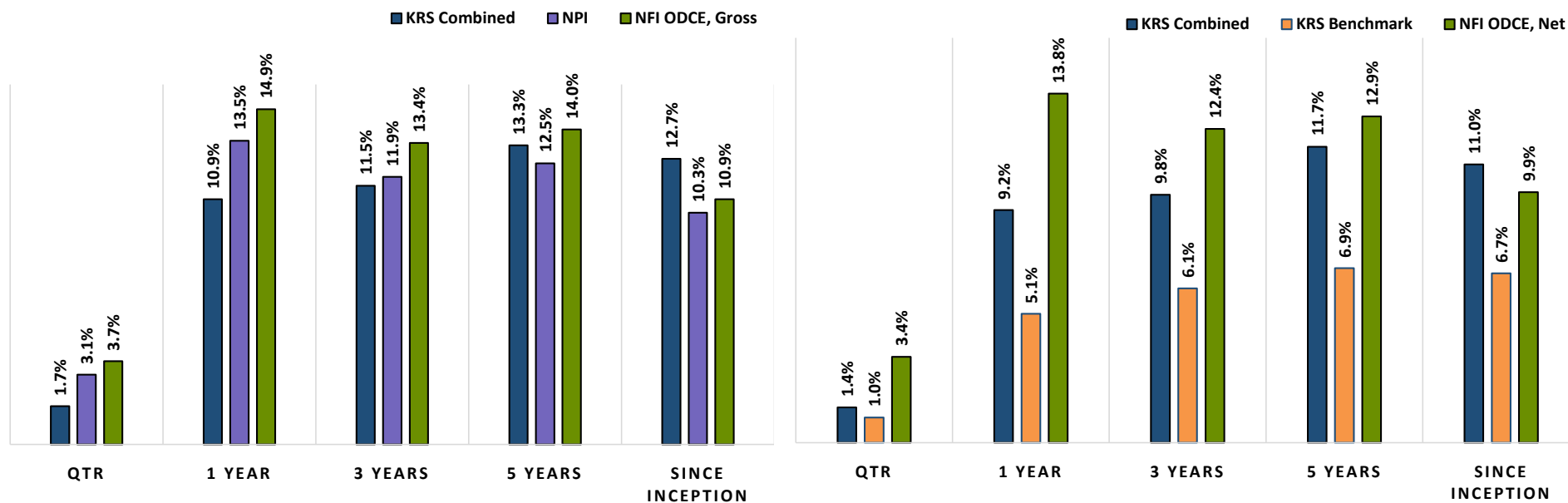
- The KRS Real Estate Portfolio made its initial investments in 2009.
- KRS currently has \$907.5 million of real estate commitments to various open and closed end funds.
- ORG does not expect that all funds will call 100% of their commitment. Some of the older funds have begun returning capital.

KRS Real Estate Performance

Time Weighted Returns, Gross of Fees

Time Weighted Returns, Net of Fees

As of September 30, 2015



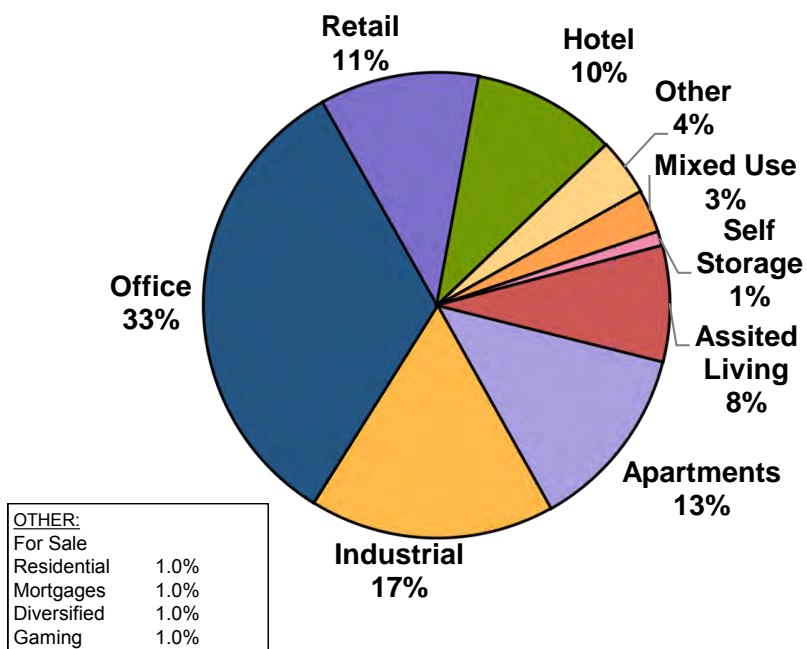
- The KRS Benchmark is a real rate of return (adjusted for inflation) of 5.0%, net of investment management fees.
- The KRS Real Estate Portfolio continues to perform well.
- The Since Inception return is 110 basis points greater than the NCREIF ODCE index, net of fees and 430 basis points greater than the KRS Benchmark.



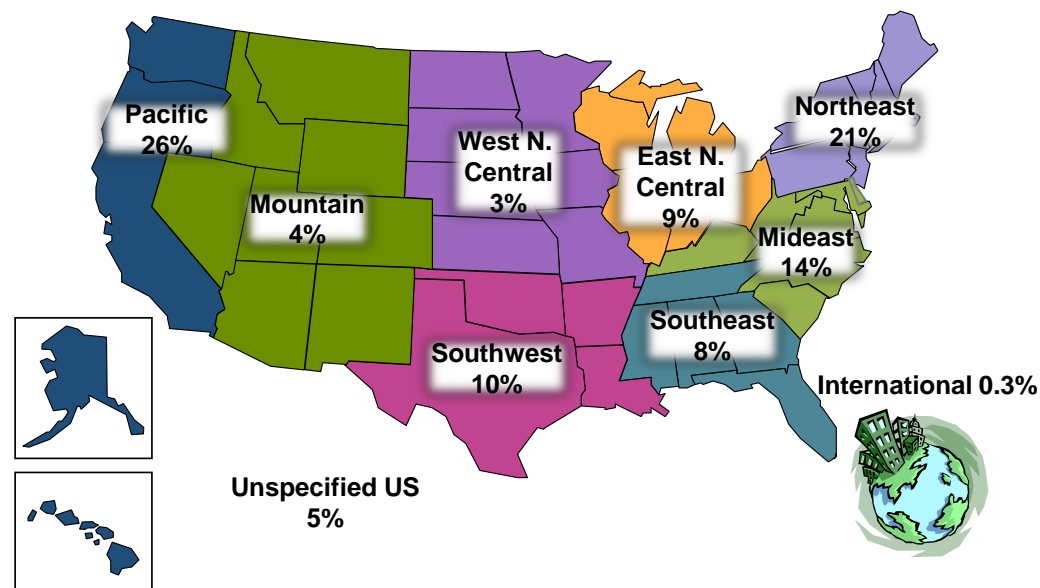
KRS Real Estate Portfolio Diversification

Property Type Diversification

Based on Market Value as of September 30, 2015



Geographic Diversification



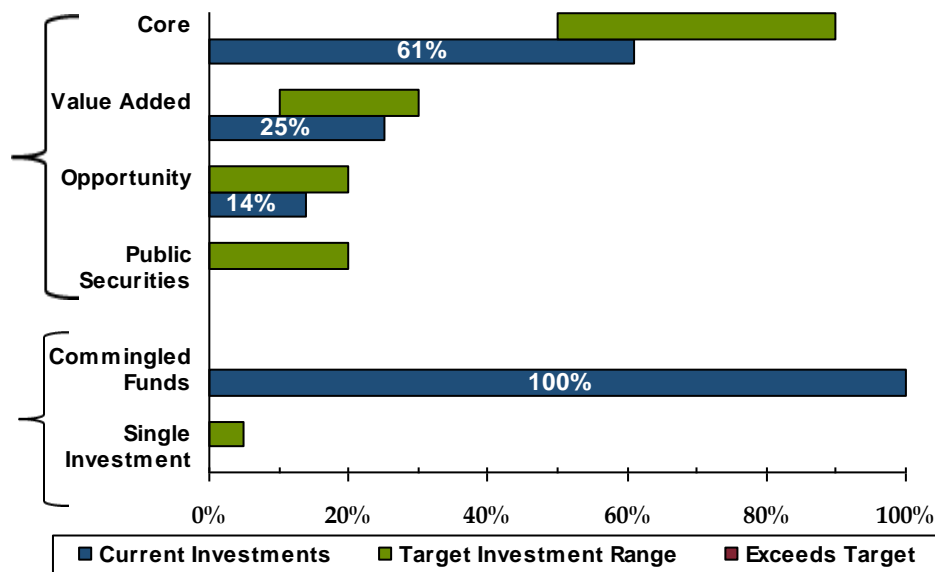
- The KRS Real Estate Portfolio is well diversified by property type and geographic locations.



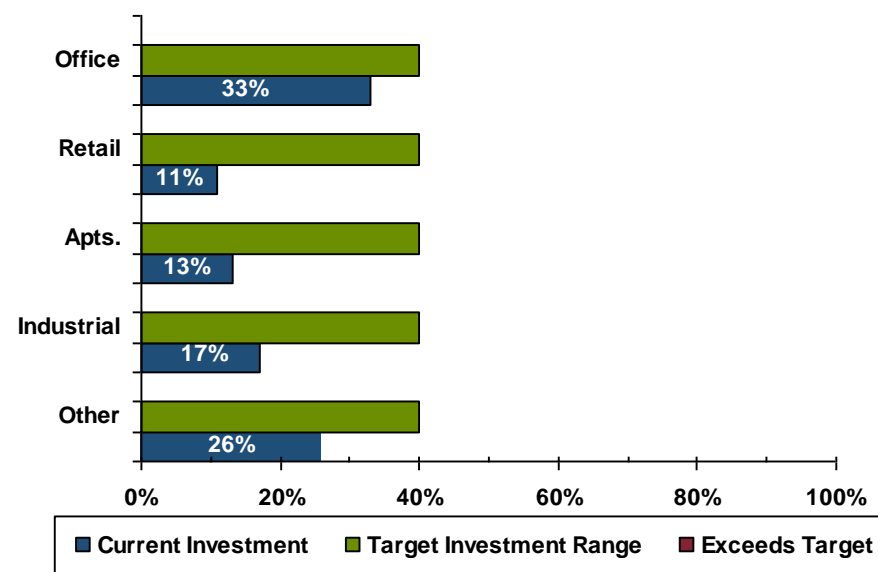
KRS Real Estate Portfolio Compliance

Portfolio Diversification

As of September 30, 2015



Property Type Diversification



- The KRS Real Estate Portfolio is within the ranges for both the Portfolio and Property Type Diversification.

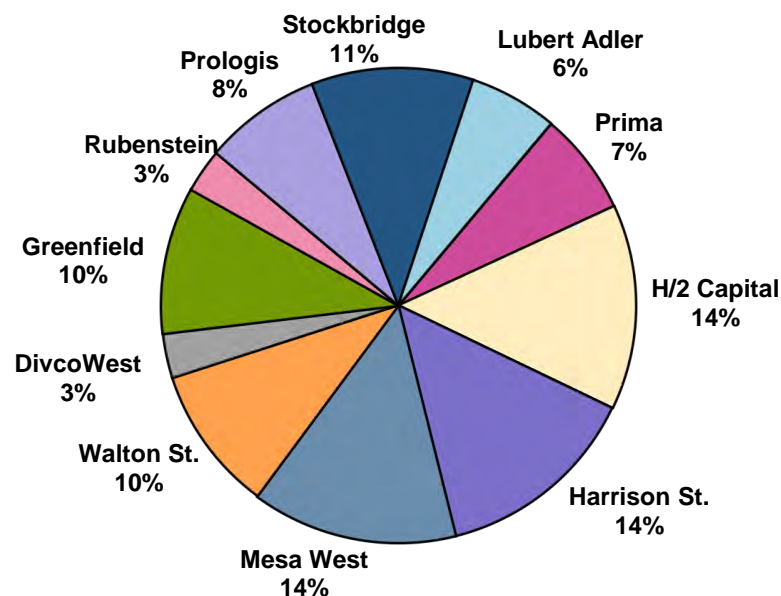
Compliance with Policy:



KRS Real Estate Portfolio Compliance

Investment Manager Diversification

Based on Commitments as of September 30, 2015

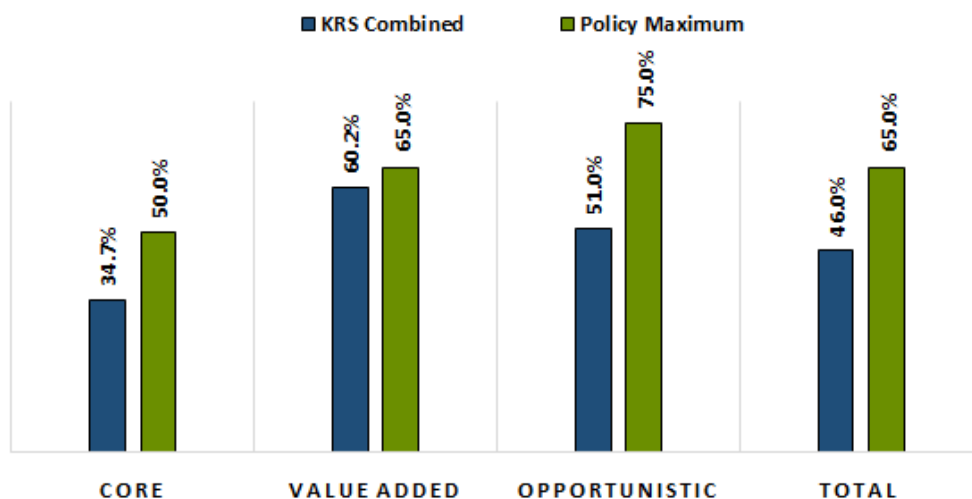


Policy Target is 20% Committed to One Manager (\$157.0 million)

- The KRS Real Estate Portfolio meets the Investment Manager Diversification and the Leverage Ratio targets.

Leverage Ratio

Based on Market Value as of September 30, 2015



Policy Target is 65% Total Portfolio Leverage

Compliance with Policy:



KRS Real Estate Portfolio Performance Returns – Pension Plan

Based on Market Value as of September 30, 2015

Investment	Vintage Year	Strategy	Commitment	Capital Contributions	Distributions	Net Asset Value	Net Multiple	Net IRR
DivcoWest Fund IV REIT, LLC	2013	Opportunistic	\$20,800,000	\$17,245,947	(\$2,605,974)	\$21,316,347	1.4x	28.5%
Greenfield Acquisition Partners VI, L.P.	2012	Value Added	38,120,000	36,569,127	(22,951,886)	31,068,891	1.5x	16.9%
Greenfield Acquisition Partners VII, L.P.	2013	Value Added	27,800,000	14,683,349	(7,102,978)	16,300,665	1.6x	11.1%
H/2 Core Debt Fund, LP	2014	Core	21,100,000	21,100,000	(2,360,991)	21,339,323	1.1x	7.5%
H/2 Credit Partners, L.P.	2011	Value Added	76,900,000	76,900,000	0	99,726,052	1.2x	6.4%
Harrison Street Core Property Fund, L.P.	2011	Core	92,540,000	92,540,000	(15,105,436)	106,211,434	1.3x	9.3%
Lubert-Adler VII, L.P.	2014	Opportunistic	34,750,000	10,425,000	(170,445)	9,653,858	0.9x	-10.7%
Mesa West Core Lending Fund, L.P.	2013	Core	57,500,000	57,500,000	(8,136,748)	58,457,003	1.1x	6.6%
Mesa West Real Estate Income Fund II, L.P.	2008	Value Added	36,000,000	30,035,381	(38,679,973)	3,125,162	1.4x	13.1%
PRIMA Mortgage Investment Trust	2008	Core	45,000,000	45,000,000	(18,566,412)	53,822,962	1.5x	9.4%
Prologis Targeted US Fund, L.P.	2013	Core	51,000,000	51,000,000	(1,167,749)	54,644,010	1.1x	15.8%
Rubenstein Properties II, L.P.	2013	Value Added	20,800,000	8,634,423	(7,195,070)	8,600,924	1.8x	22.7%
Stockbridge Smart Markets Fund, L.P.	2013	Core	69,000,000	69,000,000	(3,777,391)	75,629,490	1.1x	12.7%
Walton Street Fund VI, L.P.	2008	Opportunistic	36,000,000	28,728,424	(22,673,987)	25,113,336	1.9x	10.7%
Walton Street Fund VII, L.P.	2012	Opportunistic	38,120,000	27,998,758	(1,510,094)	34,805,710	1.3x	21.3%
			\$665,430,000	\$587,360,409	(\$152,005,134)	\$619,815,167		

KRS Real Estate Portfolio Performance Returns – Insurance Fund

Based on Market Value as of September 30, 2015

Investment	Vintage Year	Strategy	Commitment	Capital Contributions	Distributions	Net Asset Value	Net Multiple	Net IRR
DivcoWest Fund IV REIT, LLC	2013	Opportunistic	\$9,200,000	\$7,628,016	(\$1,152,643)	\$9,428,383	1.4x	28.5%
Greenfield Acquisition Partners VI, L.P.	2012	Value Added	16,755,000	16,073,340	(10,088,113)	13,655,804	1.5x	16.9%
Greenfield Acquisition Partners VII, L.P.	2013	Value Added	12,200,000	6,443,772	(3,117,136)	7,153,529	1.6x	11.1%
H/2 Core Debt Fund, LP	2014	Core	8,900,000	8,900,000	(660,729)	9,000,879	1.1x	4.2%
H/2 Credit Partners, L.P.	2011	Value Added	22,800,000	22,800,000	0	28,380,129	1.2x	6.1%
Harrison Street Core Property Fund, L.P.	2011	Core	31,010,000	31,010,000	0*	39,161,850	1.3x	9.2%
Lubert-Adler VII, L.P.	2014	Opportunistic	15,250,000	4,575,000	(74,800)	4,236,585	0.9x	-10.7%
Mesa West Core Lending Fund, L.P.	2013	Core	25,500,000	25,500,000	0*	29,134,531	1.1x	7.6%
Mesa West Real Estate Income Fund II, L.P.	2008	Value Added	4,000,000	3,337,265	(4,302,937)	347,237	1.4x	13.2%
PRIMA Mortgage Investment Trust	2008	Core	21,500,000	21,500,000	(4,576,567)	22,745,526	1.2x	6.9%
Prologis Targeted US Fund, L.P.	2013	Core	19,000,000	19,000,000	0*	20,605,564	1.1x	15.8%
Rubenstein Properties II, L.P.	2013	Value Added	9,200,000	3,819,072	(3,170,520)	3,804,255	1.8x	22.4%
Stockbridge Smart Markets Fund, L.P.	2013	Core	26,000,000	26,000,000	0*	30,017,047	1.2x	13.6%
Walton Street Fund VI, L.P.	2008	Opportunistic	4,000,000	3,192,047	(2,519,212)	2,790,371	1.9x	10.7%
Walton Street Fund VII, L.P.	2012	Opportunistic	16,755,000	12,306,380	(663,736)	15,298,260	1.3x	21.3%
			\$242,070,000	\$212,084,892	(\$30,326,393)	\$235,759,950		

* Distributions are reinvested.

Biographies



Biographies

Edward Schwartz, Principal

Mr. Schwartz is a co-founder of ORG Portfolio Management LLC (ORG) and has over 20 years of experience in real estate consulting. Mr. Schwartz's vision and planning, along with co-founder Jonathan Berns, has resulted in ORG's growth and standing as a premier institutional real estate consulting firm. Mr. Schwartz also participates in and administers the firm's review of investment managers, co-investment opportunities and secondary offering purchases. He formulates ORG's economic and real estate market opinions and develops client portfolio strategies. Mr. Schwartz is a voting member of ORG's Investment Committee. Prior to forming ORG in 1999, Mr. Schwartz was a consultant with The Townsend Group where his clients included some of the largest public and private US pension plans. As a consultant, his responsibilities included investment manager reviews and strategic portfolio construction. He served as Portfolio Manager for a limited partnership with 350 taxable investors, overseeing in excess of \$1 billion of real estate assets. Mr. Schwartz participates on The Institutional Real Estate Letter's Editorial Advisory Board and is an active member of Pension Real Estate Association (PREA). He is a frequent panelist and speaker at industry conferences and educational forums for public pension plan staff and trustees. Mr. Schwartz has authored articles for a variety of pension and real estate focused publications and has been quoted in The Wall Street Journal relative to his opinions on real estate issues. Mr. Schwartz has a Master of Science in Business Administration with a concentration in Finance from Weatherhead School of Management, Case Western Reserve University and a Bachelor of Arts in Economics from Kenyon College.

Jonathan Berns, Principal

Mr. Berns is a co-founder of ORG Portfolio Management LLC and has been active in the real estate and consulting industry for over 25 years. Mr. Berns has dedicated his time and vision, along with co-founder Edward Schwartz, to growing ORG into a premier real estate consulting firm. As a senior investment professional, Mr. Berns is directly involved in and administers client service, investment fund and real asset due diligence, portfolio strategy and manager oversight. He also is responsible for the oversight of the ORG Diversified Real Estate Portfolio, a separate entity that owns and manages a \$150 million investment portfolio including apartment, office, retail and industrial properties. Mr. Berns is a voting member of the ORG Investment Committee. Prior to forming ORG in 1999, Mr. Berns was president of Berns Properties, Inc., a real estate development, investment and consulting company that he founded in 1984. Acting as a consultant under Berns Properties, Mr. Berns was responsible for negotiating an investment by Nuon International, a \$2 billion Dutch utility, in North Coast Energy, as well as consulting in the acquisition of two large research facilities located in Michigan and Pennsylvania. Mr. Berns is a past chairman of the First Suburbs Consortium, a nationally recognized government-led advocacy organization focused on redevelopment of urban property, and has been a national speaker on real estate investment strategies, urban redevelopment and energy utilization optimization and procurement. Mr. Berns is a member of Pension Real Estate Association (PREA). He has a Bachelor of Science in General Science from the University of Michigan.



Biographies

Barbara McDowell, CEBS, Consultant

Ms. McDowell joined ORG in 2003 and has over 20 years of experience in the institutional real estate industry. Ms. McDowell manages ORG's client reporting, performance measurement, portfolio compliance and monitoring. She also serves as ORG's Chief Compliance Officer. Prior to joining ORG, Ms. McDowell spent 10 years with the SBC Communications Inc.'s Master Pension Trust (SBC Master Pension Trust) as Director of Real Estate and Alternative Investments. Ms. McDowell managed the Trust's real estate asset class investments, including private and public real estate and private equity. Throughout her career Ms. McDowell has been active in Pension Real Estate Association (PREA) and was a member of the Plan Sponsor Executive Council. In 2000, she chaired the Plan Sponsor PREA conference. Prior to working with the SBC Master Pension Trust, Ms. McDowell held various positions at SBC Communications Inc. in Finance, Audit and Information Systems acquiring significant experience and knowledge of compliance and audit procedures, financial reporting, investment and risk management and oversight. Ms. McDowell is a member of National Council of Real Estate Investment Fiduciaries (NCREIF). She has been a member of the Real Estate Information Standards (REIS) Council and remains active in the organization's task forces. Ms. McDowell has a Bachelor of Arts in History from the University of Houston, and a designation as a Certified Employee Benefit Specialist (CEBS).

Rebecca Morris, Consultant

Ms. Morris has worked with ORG since 2007. Her primary responsibilities include investment fund due diligence and on-going investment manager review and monitoring. She assists with client service and research projects. Prior to joining ORG, Ms. Morris worked at Impact Capital, a consortium of insurance companies, evaluating investment opportunities in private equity and real estate investment funds. She was President of California Capital Alliance, an organization whose focus was finding funding for businesses and infrastructure in lower income communities in California. Ms. Morris also served as Investment Advisor to the Secretary of Trade and Commerce for the State of California, where she headed a program responsible for promoting job-creating infrastructure investments by private equity and real estate funds in the state of California and advising on industrial development bond issues. Ms. Morris also previously was a special assistant to California Insurance Commissioner John Garamendi. Ms. Morris served in the United States Army Reserves with a mission specialty of Psychological Operations. She has a Master of Business Administration in Finance from Anderson School of Management at UCLA, a Master of Arts in International Business and was a Rotary Scholar at the University of Leeds, England, and a Bachelor of Science in Marketing Management from California Polytechnic University.



Biographies

Katie Zarback, Consultant

Ms. Zarback joined ORG in 2004. She has over 12 years of institutional real estate experience, including asset management, and project management and implementation. As the firm's senior Asset Manager, Ms. Zarback is responsible for creating and managing customized asset management strategies for client-owned real estate investments. Her focus is on maximizing the total return for each asset through the analysis of property efficiencies and identifying opportunities for improved performance, as well as oversees the asset disposition process. She works closely with third party property managers and leasing agents to provide direction for and oversight of business plans, risk management, budgets, forecasts, lease analysis and negotiations, and capital investment approvals. Ms. Zarback has extensive experience in real estate operations, asset level analytics, legal practices and policies, and investor reporting procedures. She has had significant involvement in managing project-based direct investment analysis and research on behalf of clients over the years. Prior to her current role, Ms. Zarback spent several years managing client service initiatives and relationship management, as well as being deeply involved in the acquisition and management of direct real estate investments. Ms. Zarback currently is enrolled in the Master's program for Communications Management at John Carroll University and has a Bachelor of Arts in Communications from John Carroll University.

Bria Macon, Database Administrator

Ms. Macon joined ORG in 2009 and has primary responsibility for managing ORG's research efforts and supporting due diligence activities by maintaining the information and integrity of ORG's proprietary database. Ms. Macon focuses on obtaining information and researching investment manager strategies and fund-level data. She coordinates the collection of questionnaires, marketing materials, reports and general information from investment managers for the database that facilitates ORG's client recommendations and investment decision making process. Ms. Macon also is responsible for obtaining quarterly reports and periodical data for client invested funds. Prior to joining ORG, Ms. Macon gained significant experience in research and reporting procedures for state and local governing bodies serving as an Administrative Assistant and Analyst for the City of Burbank's Management Services Department in California, where her main responsibilities included maintaining historical files, preparing documents for City officials and organizing City meetings. She also conducted surveys, created reports and provided research for union negotiations with the City. Ms. Macon has a Bachelor of Arts in Communications from Howard University.



Biographies

Heathyr Ullmo, Manager, Portfolio Analytics

Ms. Ullmo joined ORG in March 2014 with over 14 years of experience in the financial industry. She is responsible for managing the statistical data in ORG's proprietary database, including cash flows and performance information. Ms. Ullmo also prepares client quarterly reports and manages fund and performance-related special projects. Prior to joining ORG, Ms. Ullmo was the Business Development Officer and Treasury Management Sales Officer at Peoples Bank f/k/a Ohio Commerce Bank, where her primary responsibilities were client relationship management and building and managing the bank's commercial loan portfolio gaining a deep understanding of legal compliance policies for the investment banking and finance industry. Ms. Ullmo negotiated and structured loans for financial feasibility and industry analysis, as well as financial and investor reporting. During her tenure, she managed the commercial loan portfolio transition when Ohio Commerce Bank was bought by Peoples Bank. Ms. Ullmo has a BA in Business Administration with a concentration in Finance from Malone College.

Yichao Mark, Analyst - Research & Consulting Services

Yichao joined ORG in August 2015 and is responsible for conducting research to support the firm's investment theses, following capital market activity, analyzing statistical data, and developing financial models for investment due diligence. Yichao also assists with evaluating the capabilities of real estate managers and investment strategies, performing asset level analytics, and managing specific client research requests. Prior to joining ORG, Yichao worked for Markets Group (formerly US Markets) where he worked in an investor relations capacity to develop regional institutional investor forums across the USA. Prior to Markets Group, he worked in investor relations at MacKenzie Partners and as an intern at UBS Wealth Management. Before beginning his career in the financial industry, he was a CRTA (Cancer Research Training Award), working with bioinformatics at the National Institutes of Health. Yichao has a Bachelor of Arts in Biology from Boston University. He is also a candidate in the CFA Program.

Rachel Martin, Support Specialist - Research & Consulting Services

Ms. Martin joined ORG in December 2014 and is responsible for supporting the development and implementation of marketing and research strategies and client initiatives. Ms. Martin works on actively gathering manager and investment opportunity information and reviewing data submissions to support ORG's proprietary database activities. She plays an integral role in the firm's research efforts and the development of client deliverables and marketing materials, as well as assisting with responses to requests for proposals. Ms. Martin has a Bachelor of Business Administration with a concentration in Managerial Marketing from Kent State University.



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Memo

To: Andy Kiehl

From: Ed Schwartz, Jonathan Berns

CC: ORG Investment Committee

Date: January 12, 2016

Re: Patron Capital V, L.P.

RECOMMENDATION

ORG Portfolio Management LLC (“ORG”) recommends that Kentucky Retirement System (“KRS”) invest up to €50 million in Patron Capital V, LP (the “Fund”), a private equity real estate fund formed by Patron Capital Advisers, LLP (“Patron”) to invest in commercial real estate assets located primarily in Western Europe. The Fund will target small to middle-market transactions in the €30 - €90 million range with a primary focus on the United Kingdom, Germany, Spain, Ireland, The Netherlands, France and Italy.

The Fund represents the fifth investment vehicle for this group of professionals as a team. The Fund is sponsored by Patron Capital Advisers, LLP (“Patron”). Patron was formed in 1999 by Keith M. Breslauer and Patron has raised over €2.5 billion since its inception. A more detailed historical explanation is provided in the “General Background” and “Track Record” section of this report. Information presented in this report includes ORG comments on the Fund, as well as excerpts from various Fund documents provided by Patron.

ORG performed due diligence on the Fund to determine the feasibility of the investment vehicle for the KRS real estate portfolio. Our due diligence included the following:

- A complete organizational review.
- A macro investment environment review to determine whether the proposed investment strategy was viable in the current economic environment.
- A topical review of the latest performance numbers for all realized and unrealized investments.

- A review of the relevant fund documents including the Private Placement Memorandum and recent quarterly reports and audited financial statements for prior funds.
- Meetings with Managing Members in Cleveland and at the manager's office located in London.
- Meetings with other Funds with similar investment strategies.

Patron is targeting a fund size of €750 million (which may be increased to €1.1 billion at the discretion of the GP) with a projected gross IRR of 17% to 22% and a gross equity multiple of 1.7x.

ORG believes the Fund opportunity represents a viable investment vehicle for KRS to invest with a seasoned management team and gain exposure to commercial real estate investments located primarily in Western Europe.

SUMMARY OF INVESTMENT ATTRIBUTES

Investment Merits

- Strategy is timely based on current economic conditions.
- Manager has shown that they are nimble and can execute niche investment strategies.
- Manager completes a high level of research on all investments and is able to fluidly discuss even the smallest details.
- Management team includes former operators of some of the proposed investment targets.
- Much of the Investment team has worked together for numerous years, either directly or through investment partner arrangements.

Risks

- Patron's track record is largely unrealized.
 - Fund II, which began investing in 2004 has returned approximately 56% of the capital and is projecting a gross IRR of 2% and a gross equity multiple of 1.1x.
 - Fund III, which began investing in 2007 has returned approximately 35% of the capital and is projecting a gross IRR of 5% and a gross equity multiple of 1.3x.
 - Fund IV, which began investing in 2012 has returned approximately 40% of the capital and is projecting a gross IRR of 28% and a gross equity multiple of 2.0x.

Manager's assumptions appear to be realistic for projected returns for the more recent funds and realized investments for Fund III and Fund IV have largely met the Manager's target returns.

- The Manager has numerous investments, which are unrealized and require the investment team's time and attention to fully execute the business plans.

Manager has a significant investment team and support staff in place.

- Success in some of the investment targets requires ground level operations knowledge and/or the creation of an operating company.

Patron has demonstrated sufficient expertise in the operating company investment platforms.

- Strategies and target investments seem to be somewhat unrelated requiring diverse levels of expertise.

The diverse strategies also enhance portfolio diversification.

GENERAL BACKGROUND

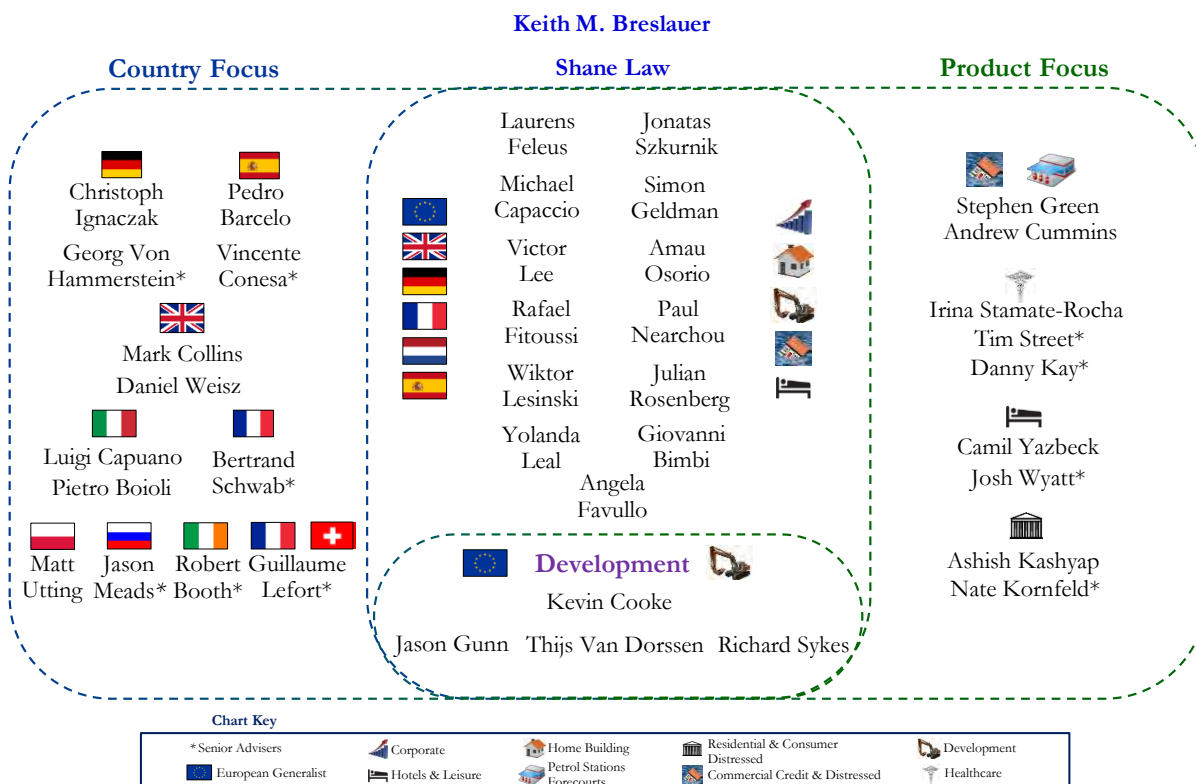
Patron was established in 1999 by Keith Breslauer to make value oriented and opportunistic real estate and real estate related investments primarily in Western Europe. Since its founding, Patron has raised over €2.5 billion of equity capital from over 100 primarily institutional investors including sovereign wealth funds, corporate pension plans and endowments across five funds and co-investment pools. As of January 2016, €2.2 billion of equity with over €9 billion of gross asset value has been invested predominately across Western Europe. Patron has operations across Europe with its main advisory offices in the UK and Luxembourg and additional offices in Germany, Spain and Italy.

Patron's team consists of a total of 73 dedicated professionals led by founder and Managing Director, Keith Breslauer. The team has expertise in acquisitions, asset management, development, finance and operations. Patron's in-house team is supplemented by its extensive network of long standing relationships with local participants, intermediaries, management teams and originators throughout Europe.

Patron's investment team consists of 41 investment professionals and senior advisers (the "Investment Team") who are highly skilled in their respective areas of focus, averaging 18 years of experience, with the Patron senior partners averaging 23 years of experience. Working on a granular, product and country specific basis, the Investment Team operates effectively as an owner operator and is therefore well positioned to capitalize on investment opportunities that arise as markets throughout Western Europe move through their respective cycles. In addition to the experienced product and country specialists, the Investment Team includes a dedicated in-house development team (the "Development Team") consisting of four professionals with significant property industry experience who contribute to the underwriting and ensure local partner performance for their respective investments. Patron's Investment Team has been highly cohesive as a result of low turnover and because many members of

the team spent a significant portion of their careers working together either at Patron or with Patron personnel in their previous roles.

Patron's Investment Team:



The Investment Team works closely with a 31 person support team (the “Support Team”), which includes key legal, finance and tax, structuring and compliance professionals whose work is instrumental at both the origination stage and during the implementation of business plans. The Support Team also includes a fully staffed Luxembourg organization, which offers a valuable structuring advantage for many of Patron’s investments.

INVESTMENT STRATEGY

The Fund will continue the successful strategy of its predecessor (Fund IV), focusing predominantly on Western Europe, as Patron believes this region remains an attractive investment environment in the near term, which will extend Patron’s proven historic performance in the region. The Fund will focus on opportunistic and value oriented investments, primarily targeting distressed and/or undervalued property and property related assets, loans and corporate entities. Specifically, it will target middle market transactions that typically require initial equity commitments in the range of €30 million to €90 million, and in certain cases, will expand to larger commitments based on the respective investment plans. The Fund may also opportunistically invest in attractive larger scale transactions that are consistent with this strategy and meet its risk adjusted return objectives. In these circumstances, the Fund may use

co-investment capital from the Fund's investors, in priority, as utilized for relevant investments in prior funds. The Fund will aim to invest in non-competitive situations, originated through Patron's extensive network of long standing relationships with local participants, financial institutions, investment banks, private equity partners, local advisers and agents.

Target Return

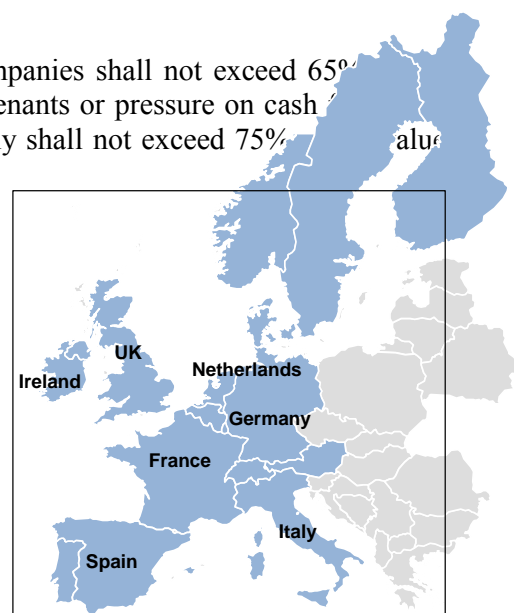
The Fund projects a gross IRR of 17% to 22% and a gross equity multiple of 1.7x.

Use of Leverage

The aggregate of property related borrowings of all portfolio companies shall not exceed 65% of the value of the properties unless such increased debt has limited covenants or pressure on cash flow. The aggregate property borrowings of any individual portfolio company shall not exceed 75% of the value of the properties.

Geographic Focus

The Fund will have a primary focus on the United Kingdom, Germany, Spain, Ireland and the Netherlands and a secondary, opportunity driven focus on France and Italy.



Target Investment Types

Patron's investments largely fall into four primary strategic themes: distressed, undervalued, non-core and complex, in all cases targeting opportunities with assets that are below fundamental intrinsic value:

Fund Strategic Overview

Distressed	60-70%
<ul style="list-style-type: none"> • Bank driven sales/liquidations • Liquidity constrained operators/borrowers/developers 	
Businesses with underlying property below intrinsic asset value	30-40%
<ul style="list-style-type: none"> • Asset based expansion with complete entity exit • Companies with strong cash flow supported by underlying real estate assets • Appropriate asset break up and sale with subsequent entity exit or shut down 	
Institutional Non-Core (ex-distressed)	0-10%
<ul style="list-style-type: none"> • Property assets below intrinsic value deemed non-core by parent/owner 	
Complex Situations	0-5%
<ul style="list-style-type: none"> • Attractive property fundamentals encumbered by complex situations 	

Within the four primary themes, Patron identifies granular micro themes, including specific asset subcategories and geographic markets, in which these features and other attractive market dynamics are most prevalent and where the benefit of Patron's depth and breadth of experience can be brought to bear most effectively. Given the dislocated economic and market environment, Patron expects to capitalize on such pockets of opportunity across Western Europe over the near term. Examples of primary micro themes for focus are:

Primary Micro Themes

- **Commercial Bank and Financial Institution Inventories:** European financial institutions have large portfolios of distressed commercial real estate loans and foreclosed real estate assets on their balance sheets that are considered non-core and have prioritized the need to liquidate the positions with increased urgency.
- **Liquidity Constrained Opportunistic Partners:** Opportunistic local partners that have identified opportunities but lack the necessary capital, given reduced local leverage.
- **Distressed and Overleveraged Developer/Investors:** Developers and investors that have come under pressure to liquidate assets due to overleveraging.
- **Public and Private Asset Rich Corporates with Liquidity Problems:** Such companies are typically capital constrained either due to lack of financing available in the debt markets or the limited capital of their founding sponsors.
- **Dislocated Mortgage Markets (residential and commercial) and Defaulted Securitized Assets:** Acquisition of portfolios, performing and non-performing as well as participating in certain mortgage backed loans and related opportunities.

Patron believes that its established platform as a pan-European opportunistic real estate investor, with experience and expertise in analyzing and underwriting diverse real estate assets in multiple geographies, its granular asset focus, local asset management capabilities and its ability to address complex corporate related issues, makes Patron ideally positioned to properly underwrite and capitalize on the current and anticipated deal flow.

MANAGEMENT FEES

Management fees during the investment period are 1.75% per annum on the commitment amounts. After the investment period, the management fee is 1.50% per annum on the aggregated acquisition cost of any unrealized investments.

TRACK RECORD

Patron has had four prior funds and one initial pool of capital, which was invested in one asset. The single asset Fund, referred to as the Patron Capital Captive Fund, was comprised of one investment totaling €105 million. This investment was realized in less than two years and returned over €244 million, generating a gross IRR of 75% and a gross equity multiple of 2.3x on invested capital.

Patron Capital, I L.P. (“Fund I”) closed in 2002 with \$110 million of commitments and generated an additional \$27 million of callable commitments. Fund I’s investment period began in June 2001, and completed its last investment in November 2005. It was a U.S. dollar denominated fund and is fully liquidated. Fund I invested a total of \$114 million in 13 transactions in Western and Central Europe. The Fund realized \$216 million with a gross IRR of 53% and a gross equity multiple of 1.9x. In order to compare prior funds to Fund V, Patron provided returns for Western Europe only in Fund I – 46% gross IRR and gross equity multiple of 1.8x.

Patron Capital, II L.P. (“Fund II”) closed in October 2004 with total commitments of €303 million and generated an additional €76 million of callable capital. Fund II’s investment period began in November 2005 and completed its last investment in February 2008. As of March 31, 2015, Fund II had invested a total of €354 million, plus an additional €26 million of co-investment capital in 11 investments and programs, with an additional €1 million identified for potential capital expenditure within existing investments. Fund II has realized €202 million to date (representing 57% of capital invested) and expects to realize an additional €138 million in proceeds for a projected gross IRR of 2% and a gross equity multiple of 1.1x. In order to compare prior funds to Fund V, Patron provided returns for Western Europe only in Fund II – 6% gross IRR and gross equity multiple of 1.1x.

Patron Capital, III L.P. (“Fund III”) closed in March 2007 with total commitments of €867 million. Fund III’s investment period began in July 2007 and completed its last investment in June 2012. As of March 31, 2015, Fund III comprised 16 investments and programs, and includes invested capital of €731 million and additional capital committed and approved to these transactions of €52 million. Fund III has realized €260 million to date (representing 35% of capital invested) and expects to realize an additional €727 million in proceeds for a projected IRR of 5% and a gross equity multiple of 1.3x. In order to compare prior funds to Fund V, Patron provided returns for Western Europe only in Fund III – 9% gross IRR and gross equity multiple of 1.6x.

Note: These projected returns reflect a comparatively low 33% loan-to-cost ratio across the portfolio also given the slower pace of investments implemented during the financial crisis and the program format of many of the investments, the weighted average life of capital to date is 4.6 years and is 5.8 years for the overall weighted average life of the investments.

Patron Capital, IV L.P. (“Fund IV”) closed in July 2012 with total commitments of €781 million, including the 1% from the General Partner with an additional €100 million discretionary dedicated co-investment pool raised from a single Fund IV investor. Patron IV invested only in Western Europe. As of September 30, 2015, Fund IV had invested a total of €450 million, plus an additional €275 million of co-investment capital (€45 million from the co-investment pool across 3 investments and €230 million from two third party investors in relation to the CALA Homes investment), in 17 investments and programs, with an additional €175 million identified for potential capital expenditure within existing

investments. Fund IV has realized €307 million through September 30, 2015 for a projected gross IRR of 28% and a gross equity multiple of 2.0x.

SUMMARY OF OFFERING TERMS – SEE LIMITED PARTNER AGREEMENT FOR COMPLETE TERMS

The following is a summary of the terms of the Patron Capital V, L.P Partnership Agreement as contained in the Patron Capital V, L.P Private Placement Memorandum. Capitalized terms used but not defined below have the respective meanings ascribed to such terms in the Patron Capital, V L.P. Partnership Agreement. This summary is not intended to represent a legal review of the documents.

1. Complete Name of Investment Management Organization (Include fund sponsor/parent company)	Patron Capital Advisers LLP (acting in its capacity as investment adviser to the Patron Capital Funds).
2. Complete Name of Fund	Patron Capital, V L.P.
3. Who are the principals of the fund sponsor?	Keith Breslauer
4. Key Person	Keith Breslauer
5. Primary Contact Information:	<p>Keith Breslauer Patron Capital Advisers LLP One Vine Street London W1J 0AH Tel: +44 207 629 9417 Fax: +44 207 629 9418 keith@patroncapital.com</p> <p>Shane Law Patron Capital Advisers LLP One Vine Street London W1J 0AH Tel: +44 207 629 9417 Fax: +44 207 629 9418 shane@patroncapital.com</p>
6. Complete Name of General Partner	Patron Capital GP V L.P., a Jersey limited partnership acting by its general partner, Patron Capital GP V Limited, a limited company incorporated in Jersey.
7. Investment Manager of the Fund	<p>The General Partner of the Fund will act as Fund Manager. Patron Capital Advisers LLP will act as Investment Adviser</p> <p>Patron Capital Advisers LLP is an Investment Adviser and will provide portfolio and administrative services in relation to the Fund pursuant to an investment advisory agreement entered into between Patron Capital Advisers LLP and the General Partner which includes, without limitation, investigating, analyzing, structuring, due diligence, monitoring the performance of</p>

	<p>investments and preparing the investment memorandum in respect of each potential investment for review by the General Partner and its investment committee. In addition to the above, Langham Hall, the Fund administrator in Jersey, will delegate to Patron inter alia the preparation of quarterly and year end reporting (including fair value calculations).</p> <p>Patron Capital Europe S.à.r.l. is also an Investment Adviser and will provide services in relation to the Fund pursuant to an investment advisory agreement entered into between Patron Capital Europe S.à.r.l. and the General Partner which includes, without limitation, origination of investment opportunities outside of the United Kingdom, assisting in negotiations and assessing the quality of professional advisers.</p> <p>The services provided by the Investment Advisers shall at all times be as set out in their respective investment advisory agreements agreed by the General Partner, such that they shall not have any power or authority of any description to enter into any transaction on behalf of or in any way to bind the General Partner or the Fund or any of them or to effect any dealings in Investments.</p>
8. Fund Risk>Returns Category (Core, Value Added or Opportunistic)	Opportunistic
9. Fund Return Objective (Include both Gross and Net of Fees and Carried Interest)	The Fund projects a 17% to 22% gross IRR and a gross equity multiple of 1.7x.
10. Year Fund Formed	2015
11. Size Of Fund (Max and Expected)	The Fund is targeting total commitments of €750 million (excluding the General Partner's Commitment as noted below) which may be increased to €1.1 billion at the discretion of the GP.
12. Fund G.P. Commitment	The General Partner will make a Commitment of at least 1% of the total Fund Commitments as at the Final Closing Date. The General Partner may also increase its undrawn Commitment from time to time to up to 5% of the then total undrawn Fund Commitments, with the option, at the discretion of the General Partner, to increase this amount until the end of the Investment Period.
13. Fund Term	The term of the Fund will be ten years, with up to two additional one-year extensions.
14. First and Final Closing Dates	The initial closing was in June 2015. The final closing will be no later than 12 months after the initial closing.
15. Commitment Period	No longer than 12 months.

16. Investment Period	The period from the Initial Closing Date to the earlier of (i) the date falling four years from the earlier of (A) the date on which Fund Commitments equal or exceed €500 million, and (B) the Final Closing Date; (ii) the date on which the General Partner deems that the Fund is in practical terms fully invested; and (iii) the date of any resolution pursuant to the Partnership Agreement to terminate the investment period.
17. Fiscal year-end of the fund	December 31.
18. Leverage (Include basis for how leverage is calculated and the target and maximum allowable.)	The aggregate of property-related borrowings of all Portfolio Companies shall not exceed 65% of the value of the properties unless such increased debt has limited covenants or pressure on cash flow. The aggregate property borrowings of any individual Portfolio Company shall not exceed 75% of the value of the properties.
19. Fund Credit Facility	Anticipated to have a €200 million credit facility with Royal Bank of Scotland International.
20. Property Types Permitted	All property types.
21. Geographic Focus	Predominantly Western Europe.
22. Target Markets	Focus on the United Kingdom, Germany, Spain, Ireland, the Netherlands and a secondary, opportunity driven focus in France and Italy.
23. Investment Diversification Restrictions/Concentrations	The Fund will not invest more than (i) 20% of Fund Commitments in a single property or portfolio company or (ii) more than 15% of Fund Commitments in portfolio companies organized and operating principally outside of Europe (Europe being those member countries in the European Union (EU) and the European Economic Area (EEA) from time to time, those EU acceding countries, candidate countries and potential candidate countries from time-to-time (as determined by the European Council) and also Switzerland), in each case (i) or (ii) above unless Advisory Committee approval is obtained.
24. Management Fees	<p>a) 1.75% annually on the commitment amount during the investment period.</p> <p>b) Thereafter, the fees will be 1.50% of the aggregate acquisition cost to the Partnership (excluding external leverage) of any unrealized investment.</p> <p>For this purpose, the winding up of a company in which an investment is held (other than pursuant to a restructuring) and permanent write offs or the write down of an investment which is no longer actively managed (for so long as it remains written down and not actively managed) shall be treated as realizations and partial realizations will be included proportionately. The General Partner's Share is payable semi-annually in advance from drawdowns of the Limited Partners' unfunded Commitments or out of Partnership assets.</p>

25. Preferred Return/Hurdle Rate	9%
26. Distributions/Carried Interest	Subject to the Limited Partners first receiving the acquisition cost of each realized investment, the acquisition cost of each unrealized but written off investment, a 9% preferred annual return on the acquisition cost of each realized investment and their pro-rata proportion of fees and expenses and a 50% catch-up, the General Partner will receive a carried interest of 20% of profits.
27. Clawback	There will be a clawback of any carried interest distributed to the General Partner, net of taxes paid or payable, to the extent that Limited Partners have experienced a shortfall or the General Partner has received in excess of amounts that should have been distributed to it.
28. Placement Agent Fees	Placement agent fees are for the account of the General Partner.
29. Offering/Organizational Expenses	The Partnership will bear all or, in the event that any Parallel Funds are formed, its pro rata proportion of, all legal and other expenses incurred in the formation of the Fund, the General Partner and the offering of Interests in the Fund (other than placement agent fees and expenses), up to €2 million plus any applicable Value Added Tax (VAT).
30. Reporting schedule to L.P. (quarterly/annual)	<p>Patron recognizes the importance of regular, timely and accurate reporting as critical to the integrity of the investment process and its relationships with its investors. Limited Partners will be provided with detailed, frequent communications, including asset-by-asset reporting, investor capital account statements, financial statements, investment activity progress reports, updates on any significant activities in the portfolio and the aforementioned portfolio management reports, all via the secure section of the Patron website. Quarterly financial statements and audited annual statements are prepared in conformance with the highest quality standards for the Fund and for its investors.</p> <p>The Fund will furnish the following information on an annual basis, within 120 days of fiscal year-end: (i) an annual report containing audited financial statements of the Fund; (ii) an investor specific capital account statement; and (iii) a statement of any transactions between the Fund and any related entity (included within the audited financial statement).</p> <p>The Fund will also furnish the following information on a quarterly basis, within 45 days of quarter-end: (i) unaudited financial statements for the period ending; (ii) asset-by-asset reports, and (iii) an investor specific capital account statement.</p> <p>The Fund will also prepare, or cause to be prepared, and transmit within 5 months after the close of each Accounting Period of the</p>

	<p>Partnership, a report setting forth in sufficient detail transaction effected by the Partnership during such Accounting period as shall enable each Partner to prepare it U.S. Federal income tax returns (K-1 equivalent information).</p> <p>In addition, Patron has an extensive secure website that outside of the quarterly and annual reporting schedule provides updates on its investments (financial, board packs, minutes, asset management reports, corporate/asset level updates, strategy, other), portfolio level information, including above quarterly and annual reporting, risk reports and debt schedules, and pipeline of new activity. In addition a Key Next Steps document is also produced updated every 2 weeks. This document provides a summary of each existing investment in the form of key bullets with the key action points/areas of focus. For the older investments it also details the main achievements/actions over the previous 12 months and is a useful tool for investors who want a quick snapshot of a specific investment or fund activity. On top of all this there is an additional password protected investor portal for its investors to access their own financial information including capital account statements, capital calls, distributions, annual and quarterly reports and K-1 equivalent information.</p>
31. Key Person Provision	<p>In the event that at any time prior to the end of the Investment Period Keith Breslauer either: (i) ceases to be actively involved in the business of the Investment Advisers (other than as a result of (iii) below); (ii) ceases to devote substantially all his business time to the extent necessary to properly manage the affairs of the Partnership (other than as a result of (iii) below and excluding time required in respect of any other vehicles related to or in the Fund and in respect of any other fund or pool of capital managed or advised by the Investment Advisers or by any affiliate of the Investment Adviser); or (iii) is continuously incapacitated for at least 6 months (each a “Keyman Event”), then the General Partner shall be suspended from issuing any additional drawdown notices with respect to new investments and a Fund suspension period shall commence. The General Partner will notify the Limited Partners of any circumstance whereby the Keyman has been continuously incapacitated for a period of three months, if the General Partner reasonably believes it could substantially adversely affect the Keyman’s capacity. The Fund suspension period shall continue for a period of six months and during such period Partners in the Fund may:</p> <p>(i) by the consent of the Partners representing two-thirds of aggregate Fund Commitments, approve the resumption of</p>

	<p>drawdowns for new investments (which will immediately end the Fund suspension period); or</p> <p>(ii) approve a resolution between the Partners holding 80% of Fund Commitments electing to terminate the Investment Period.</p>
32. Co-Investment Policy	<p>Patron is also considering establishing a co-invest vehicle from the Fund's Limited Partners to address potentially larger investments. Details of this will be made available upon request.</p>
33. G.P. Removal (with and without cause)	<p><u>Termination of Investment Period Without Cause</u></p> <p>If, at any time after the second anniversary of the Initial Closing Date, Limited Partners in the Fund between them holding 80% of Fund Commitments so resolve, the Investment Period shall be terminated and the General Partner shall not be permitted to issue any additional drawdown notices for new investments except for investments which are in process or have been approved by the Investment Committee prior to the termination of the Investment Period and may continue to make follow-on investments.</p> <p>In the event the Investment Period is so terminated as set out above, the General Partner shall be entitled to compensation equal to one and a half times the General Partner's Share (as defined below) in respect of the accounting period immediately prior to the accounting period in which the Investment Period is terminated.</p> <p><u>Early Termination / Removal of the General Partner</u></p> <p>The Partnership shall be automatically terminated upon the insolvency or liquidation of the General Partner.</p> <p>The Partnership may be terminated or the General Partner may be removed for cause by a 66 2/3% resolution of Partners in the Fund, and as a result all future Carried Interest payable to the General Partner shall be reduced by 50%.</p> <p>The Partnership may be terminated or the General Partner may be removed for no cause by an 80% resolution of Partners in the Fund, and as a result the General Partner will receive a priority payment of its projected Carried Interest, as well as its interest as an investor and one and a half times the General Partner's Share (in respect of the accounting period immediately prior to the accounting period in which the Partnership is terminated) as compensation for early termination of the Partnership, or the General Partner's removal, as applicable.</p>

	<p>Upon termination of the Fund, no additional business shall be conducted except for such actions as shall be necessary for the winding up of the affairs of the Fund and the distribution of the assets of the Fund amongst the Partners. The General Partner (or other person so appointed) shall cause the Fund to pay all debts, obligations and liabilities of the Fund and all reasonable costs of liquidation and the remaining proceeds and assets to be distributed amongst the Partners in the same proportions as the distributions during the life of the Fund.</p>
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BIOGRAPHIES

Keith M. Breslauer – Managing Director & Senior Partner: Mr. Breslauer founded Patron Capital in 1999 and is the Managing Director of Patron Capital Advisers LLP (and held a similar position in its predecessor vehicles), the investment adviser to the Patron Capital Funds (including Patron Capital Captive Fund, Funds I - IV). In addition to his overall leadership responsibility, Mr. Breslauer is primarily responsible for leading the origination efforts of all Patron funds.

Mr. Breslauer began his career in 1988 at Lehman Brothers, where he worked originally in the Financial Institutions Group in partnership with the Mortgage Trading Group. In addition to various responsibilities related to corporate finance and capital markets, he was involved in and led many transactions in the United States distressed markets of the 1980s and 1990s. In 1993, while with Lehman Brothers, Mr. Breslauer moved to London to target distressed assets in Europe and to assist in the creation and leadership of the Principal Finance Group, established to invest Lehman Brothers' capital in financial institutions and property assets and companies. He also served as the co-head of the International Mortgage and Real Estate Department until 1997. In 1997, Mr. Breslauer left Lehman Brothers to create and manage an investment fund focusing on smaller European property opportunities. As a bridge to the ultimate formation of Patron, he established and managed Capstar Holdings Limited, a company organized in London to originate investments on an exclusive basis for the Lone Star Opportunity Fund (I), a primarily United States based real estate fund.

Mr. Breslauer's background includes numerous investments in both property and mortgage assets and operation businesses (including hotels, servicing businesses and mortgage institutions), on a pan-European basis. He has led or assisted in the acquisition of over \$20 billion in assets in several European countries and in the United States. Additionally, he has broad experience in corporate transactions ranging from mergers and acquisitions to equity and debt capital raising and structured finance.

He holds a Master of Business Administration (MBA) degree from the University of Chicago and a Bachelor of Science (BSc) degree from the New York University School of Business. Mr. Breslauer has resided in London for the past twenty-one years with his wife and four children and is a citizen of the United States.

Shane Law – Chief Operating Officer & Senior Partner: Mr. Law formally joined Patron in 2003, after working closely with Patron since 2000 on the Fund I, Simon Storage investment in his role as investment banker at Commerzbank Securities, Patron’s adviser on that transaction. Mr. Law’s COO responsibilities primarily include managing the day-to-day operations of Patron, oversight and support to the Patron team across all investments and processes, investor related matters and recruitment and overall support to the Investment Team. In addition to his COO role, Mr. Law focuses on Patron’s corporate investments and related responsibilities. Prior to joining Patron, he spent six years in investment banking focusing on European mergers and acquisitions, initially at Svenska Handelsbanken and subsequently at Commerzbank Securities. He began his professional career at Ernst & Young (London), where he spent three years as a chartered accountant. Mr. Law holds a Bachelor of Science (BSc) degree in Mathematics from the University of Durham and he is a qualified Chartered Accountant (ACA). Mr. Law resides in England and is a citizen of the United Kingdom.

Investment Team

Mark Collins – Chairman of UK Investments & Senior Partner: Mr. Collins joined Patron in 2012 with a focus on the UK real estate market. Mr. Collins has extensive experience in the property industry, including several main Board roles and most recently as Managing Director of Lloyds Bank Corporate Real Estate Business Support Unit. Prior to this, he was COO at the UK's largest property company, Land Securities Group PLC, Managing Director for UK and Europe at GE Capital Real Estate and Assistant General Manager of Property Advisory at Sumitomo Bank. Mr. Collins knowledge of the UK's property industry, high profile firms and their CEO's has been extremely beneficial for Patron in establishing new relationships and investment opportunities. In addition given his extensive experience across various company boards and corporate governance related matters, Mr. Collins currently acts in a personal capacity as Chairman on both the Generator and CALA homes Investments within Fund III and Fund IV respectively. Mr. Collins also has extensive experience at the operational and transactional levels. He was responsible for managing major change initiatives at Land Securities and on the transactional side, he was instrumental in putting together a number a number of significant property deals, including leading the first ever corporate acquisition for Land Securities of TOPS Estates PLC and creating a £540m Joint Venture with British Land. He also originated the largest ever real estate take private deal in Europe with MEPC in 2000. Mr. Collins is a chartered surveyor by training and holds a Bachelor of Science (BSc) degree in valuation and real estate management from University of West England. Mr. Collins resides in England and is a citizen of the United Kingdom.

Stephen Green – Senior Partner, Special Situations: Mr. Green joined Patron in 2009 as a Senior Partner responsible for special situations, including the origination and underwriting of real estate debt related investments, restructurings, and complex corporate opportunities. Prior to joining Patron, Mr. Green worked at Merrill Lynch for 12 years, for much of this time as Managing Director and from 2000 as Head of the Merrill Lynch European Commercial Real Estate Finance business, which covered investment property and operating real estate loan origination, underwriting, syndication and securitization. In addition to personally leading many of that group's larger transactions, Mr. Green was responsible for the overall activities of a team of 55 professionals in London, Frankfurt and Milan. Prior to joining Merrill Lynch in 1997, Mr. Green worked for 4 years with Mr. Breslauer in the real estate team at Lehman Brothers. Mr. Green holds a Bachelor of Arts ("BA") (Hons) in Physics from Oxford University and qualified as a Chartered Accountant with Ernst & Young before joining Lehman Brothers. Mr. Green lives in London and is a citizen of the United Kingdom.

Pedro Barcelo – Managing Director & Senior Partner, Spain: Mr. Barcelo is responsible for the management of Patron's office in Barcelona and has responsibility for the origination, due diligence, execution, structuring, financing and asset management of investments in Spain. Mr. Barcelo formally joined Patron in 2004, after working with Patron during that year on the refinancing of the Hotel Arts in his role as loan originator at Hypo Real Estate Bank International. Mr. Barcelo spent three years at Hypo Real Estate Bank International focusing on project & corporate loan origination, initially in London and subsequently in Madrid. Previously, Mr. Barcelo worked for one year at Enron in the underwriting department in London and also worked for two years at Hines in the development of the Diagonal Mar mixed use project in Barcelona. Mr. Barcelo holds a degree in Civil Engineering from the Polytechnic University of Catalonia and a MBA degree from IESE (Barcelona). He speaks Spanish, Catalan and English, resides in Barcelona and is a citizen of Spain.

Luigi Capuano – Managing Director & Chairman, Italy: Mr. Capuano formally became an advisor to Patron in June 2006, with an initial focus on institutional banking relationships. In 2010, he assumed day-to-day management of the Patron Italy team, with responsibility for new business and the management of existing investments. Prior to joining Patron, Mr. Capuano spent most of his professional career in the Italian banking system where, from 1990, he held senior management positions including General Director of San Paolo di Torino, Chief Executive of Banca Popolare di Novara, Chief Executive of Italfondinario, and Group Head of the Italian Bank Division of Bank Group Banca Intesa. Mr. Capuano holds a Degree in Jurisprudence from the University of Turin. He is the President of the National Tax Collectors Syndicate and of SITEBA (Bank Technology Systems). He is also a member of the Management Board of various commercial and service companies and is a member of the National Auditors Register. Mr. Capuano is a citizen of Italy and speaks Italian and English.

Laurens Feleus – Investment Director & Senior Partner: Mr. Feleus joined Patron in January 2005 and focuses on investments in the Benelux and Nordic countries. He also focuses on Patron's activities in residential real estate and financial institutions and is responsible for Patron's activities on behalf of certain investors in India. Mr. Feleus started his career in investment banking at Salomon Smith Barney (now Citigroup Investment Bank) in London in 2000. Before joining Patron, he also worked for a privately owned United Kingdom/Swiss based investment banking boutique specializing on medium sized private equity deals. He holds a Master of Arts in Financial Economics from the University of Amsterdam. He is fluent in English, German, Dutch (Flemish) and French. Mr. Feleus resides in England and is a citizen of The Netherlands.

Christoph Ignaczak – Investment Director & Senior Partner, Germany: Mr. Ignaczak joined Patron in 2012 and focuses on German investments, with responsibilities including origination, due diligence, execution, asset management and business plan implementation. Prior to joining Patron, Mr. Ignaczak worked at Acrest Property Group, a real estate development and asset management company based in Berlin, Germany, as Director where he was primarily in charge of financing and investment analysis. Previously, Mr. Ignaczak worked for more than 4 years in the real estate finance team at Merrill Lynch and started his career at Eurohypo. Mr. Ignaczak graduated from the University of Cologne with a Business Administration Degree and is CFA charterholder. Mr. Ignaczak is fluent in English and German. Mr. Ignaczak resides in England and is a citizen of Germany.

Jonatas Szkurnik – Investment Director & Senior Partner: Mr. Szkurnik joined Patron in August 2007. Mr. Szkurnik focuses on Patron's direct investments in real estate, asset backed operating companies and corporate investments, with responsibilities including deal sourcing, execution, structuring, financing, due diligence and asset management. To date, Mr. Szkurnik has been involved in investments in residential, commercial and healthcare sectors, amongst others. Mr. Szkurnik started his career in Brazil in investment banking and holds a BSc in Civil and Industrial Engineering from Pontificia Universidade Catolica (PUC-Rio) and a MBA from London Business School. He is fluent in English, Spanish and Portuguese. Mr. Szkurnik is a citizen of Brazil.

Daniel Weisz – Investment Director & Senior Partner: Mr. Weisz joined Patron in August 2006 and focuses on Patron's principally commercial real estate investments in the UK and France, including direct real estate and asset backed operating companies, with responsibilities including origination, execution and asset management. Prior to joining Patron, Mr. Weisz's career included investment banking focused on Alternative assets investment advisory at JP Morgan, alternate assets fund and equity placement, and direct European real estate and real estate related investment. He holds a BSc in Accounting and Finance from the London School of Economics. Mr. Weisz is fluent in French and Hebrew and resides in England.

Michael Capaccio – Investment Director & Senior Partner: Mr. Capaccio joined Patron in 2004 in the role of senior originator and asset manager for new investments in Romania and Italy. Mr. Capaccio was previously with Lehman Brothers in the United Kingdom and Italy, where he was co-head of the Italian real estate principal business. During his five year tenure with Lehman Brothers, Mr. Capaccio originated or was involved as a senior manager in more than €3 billion of equity, mezzanine and senior debt investments in Italy, France and Central Europe. He began his professional career at Bankers Trust Company in New York and Chicago and has over 30 years of experience in property investment, finance and development in the US and Europe. Mr. Capaccio holds a BA degree cum laude in Economics and Political Science from Rutgers University. Mr. Capaccio resides in Italy. He speaks English, Italian and French and is a United States citizen.

Ashish Kashyap – Investment Director: Mr. Kashyap joined Patron in March 2009 and focuses on Patron's investments in residential real estate debt, consumer debt and financial institutions. Prior to joining Patron, he spent two years at Merrill Lynch's structured finance group in London, where he was responsible for analytics for the group's residential real estate investments. He also has five years' experience through various operational roles at Capital One in the United States. Mr. Kashyap holds a Bachelor of Technology (B Tech) degree in Computer Science and Engineering from the Indian Institute

of Technology (India) and a Masters of Business Administration (MBA) degree from Insead (France and Singapore). Mr. Kashyap resides in England and is a citizen of the United Kingdom.

Matthew Utting – Investment Director: Mr. Utting joined Patron in 2000 and has primary responsibility for all investments in Poland. He worked previously in various analytical positions for Bank of Nova Scotia, Citibank and Bank of Montreal. Mr. Utting holds a Master of Arts degree (“MA”) in Economics and a BA with honours in Economics (Applied Studies) from the University of Waterloo. Mr. Utting resides in England, is fluent in French and conversationally proficient in Spanish, Italian and German and is a citizen of the United Kingdom and Canada.

Camil Yazbeck – Investment Director, Hospitality: Mr. Yazbeck leads all aspects of origination, acquisition, underwriting, execution and asset management of new investment opportunities as well as the strategic and operational management of assets in Patron's hospitality sector investments. Prior to joining Patron, he spent over 20 years in the hospitality industry, focusing on all aspects of hotel operations in a variety of roles throughout the world. He held several senior positions with international hotel companies, including Operations Director, Group and Area General Manager. He acquired extensive experience moving up the ranks in hotel operations, in hotel pre-openings as well as the extended stay hotel market, within independent and branded hotels including Le Meridien, Crowne Plaza, Holiday Inn, Mercure, Best Western, The Ascott Group, Citadines and Staybridge Suites. Mr. Yazbeck holds a Master of Business Administration (MBA) specialized in Hospitality Management from IMHI: Institut de Management Hôtelier International (A joint program of Cornell University (USA) and ESSEC Graduate School of Management, Paris, France), and a French BTS (Bachelor equivalent) in Hotel and Restaurant Management from the Lycée Hôtelier Château Bellerive (Grenoble Academy, Vienne, France). Mr. Yazbeck resides in England and is a citizen of France.

Andrew Cummins – Vice President, Special Situations: Mr. Cummins joined Patron's Investment Team in 2011 and focusses on investment across Europe, particularly the UK and Nordic Countries. Mr. Cummins is responsible for deal sourcing, execution, structuring, financing, due diligence, asset management and business plan implementation, with an emphasis on special situations, including real estate debt related investments, restructurings, and complex corporate opportunities. Prior to joining the Investment Team, Mr. Cummins trained as a Barrister, during which time he worked part-time in Patron's in-house legal department. Mr. Cummins was educated at the University of Edinburgh (Master of Arts (Honours), majoring in Politics and Economics; Master of Science in European and International Relations), City University (Graduate Diploma in Law) and the Inns of Court School of Law (Bar Vocational Course, Postgraduate Diploma in Professional Legal Skills). Mr. Cummins resides in England, is proficient in Swedish and is a citizen of the United Kingdom.

Simon Geldmann – Vice President: Mr. Geldmann joined Patron in 2007 working part-time during his university studies and joined full-time after graduating in 2010. Mr. Geldmann focuses on Patron's German activities with responsibilities including origination, execution, structuring, financing, due diligence and asset management. To date, Mr. Geldmann has been involved in investments across most asset classes in Germany as well as in the healthcare sector in the UK. Prior to joining Patron Mr. Geldmann worked as an intern in the shipping and property industries in China and Germany. Mr. Geldmann holds a Bachelor of Arts degree with honours in Business Management from the University of Westminster. He is fluent in English and German. Mr. Geldmann resides in England and is a German citizen.

Victor Lee – Vice President: Mr. Lee joined Patron in August 2008 and focuses primarily on UK investments with responsibilities including origination, due diligence, execution, structuring, financing and asset management. Prior to joining Patron, Mr. Lee attained a Bachelor of Arts degree with honours in History from Oxford Brookes University. Mr. Lee resides in England. He is proficient in French and is a citizen of the United Kingdom and the United States.

Irina Stamate-Rocha – Vice President: Ms. Stamate-Rocha joined Patron in 2011, with responsibilities in deal sourcing, execution, structuring, financing, due diligence and asset management of healthcare related investment opportunities. Prior to joining Patron, Ms. Irina Stamate-Rocha worked in investment banking at Rothschild, Macquarie Capital Advisers and Fortis Bank (Brussels). Her experience includes the origination and execution of transactions for private equity and infrastructure funds. Ms. Stamate-Rocha holds a Masters in Finance degree from Vlerick Leuven Gent Management School and she obtained a Bachelor in Economics from the Academy of Economics, Bucharest. Ms. Stamate-Rocha resides in England and is a citizen of Romania.

Senior Advisers

Senior advisers are senior expert independent individuals who provide services to and/or invest directly into the portfolio companies and are remunerated directly by portfolio companies or the Partnership.

Robert Booth – Senior Adviser: Mr. Booth has worked with Patron since 2007 when he began working on a joint venture with Patron through Capital Park in Warsaw. Since early 2008 Mr. Booth's primary responsibilities have been the origination and management of investments for Patron in Ireland, with a focus on distressed assets and businesses and utilizing his substantial relationships within the banking sector. Prior to working with Patron, from 2001 to 2007 Mr. Booth worked in the data centre industry where he was founder and CEO of Global Voice Networks, working in conjunction with Hewlett Packard Corporation to market data centre and outsourcing services to corporate tenants such as Google, Amazon, Microsoft, Bank of Ireland and Hutchison Whampoa. Prior to 2001, Mr. Booth established Trinity Group Limited, one of Ireland's largest computer resellers. The company, which had 45 staff and revenues of £25 million (Irish pounds), sold products on behalf of HP, Compaq, Sun, Oracle and Microsoft. He was also involved in the establishment of Trinity Commerce, an e-commerce development company which was primarily sold to Eircom. Mr Booth holds a Bachelor of Commerce Degree from University College Dublin. Mr Booth resides in Dublin and is a citizen of Ireland.

Daniel Cohn – Senior Adviser (Legal): Mr. Cohn is a corporate finance lawyer with over 15 years of experience and has worked with Patron for the last 9 years. Mr. Cohn has led large scale corporate and real estate transactions and managed teams of lawyers and other professionals in all major European jurisdictions. His range of experience includes real estate, private equity, banking and finance, M&A, MBOs & LBOs, public markets, public-to-private and joint venture transactions in multiple industry sectors across Europe. Prior to working with Patron, Mr Cohn was a senior lawyer with Berwin Leighton Paisner where he had been focusing on large scale corporate property and principal finance transactions for major United Kingdom banks and private equity funds. Mr. Cohn holds an MA in Political Science and European Law from Johann Wolfgang Goethe University, Frankfurt. He studied

law in Manchester. Mr. Cohn speaks Hebrew and German fluently, resides in England and is a citizen of Germany.

Daniel Kay – Senior Adviser: Mr. Kay has worked closely with Patron since 2008. His primary responsibilities include originating and managing investments for Patron in the real estate backed European Healthcare sector, and with Mr. Street and Patron co-founded Gracewell Healthcare in 2010. Mr Kay spent the early part of his career at Citicorp Investment Bank, later moving to HSBC working within its property finance division. In 1997 he joined Lend Lease Corporation as a Principal within its Private Equity division making real estate related investments including healthcare related joint ventures. He subsequently joined Trizec Hahn Europe, and then established a joint venture with Safeland plc, to develop a self-storage business in Italy. In 2003, through DKS Trading Limited, Mr. Kay identified and was responsible for the acquisition of Ten Harley Street Limited, a business providing flexible accommodation and services to medical practitioners through a freehold building in London's Harley Street. In 2007, in partnership with management, Mr. Kay negotiated, structured and closed the MBO of Medical Direct Group plc, one of the United Kingdom's leading providers of medical services to the United Kingdom life insurance sector, bringing in Investec Bank as a lead investor in the MBO. The business was sold to Capita plc in 2012. Mr. Kay remains a non-executive director of DKS Trading. He has BSc from the London School of Economics and resides in England and is a citizen of the United Kingdom.

Nathan ("Nate") Kornfeld – Senior Adviser: In the last eight years, Mr. Kornfeld has taken on a more active role within Patron, advising the firm's activities in residential mortgage backed investments, including the UK Residential Distressed Program. Mr. Kornfeld was President of GMAC Institutional Advisors, a \$14 billion investment management company specializing in commercial real estate at GMAC Commercial Mortgage (now Capmark) until 2005. He previously spent two years at GMAC-RFC, where he established the GMAC Venture Capital Fund to invest in residential mortgage technology companies. Mr. Kornfeld had previously founded the Phoenix Finance Group, a specialty finance company that acquired and collected delinquent credit card debt and was subsequently sold to GMAC in 1998. Between 1987 and 1996, Mr. Kornfeld worked as a managing director at Lehman Brothers, where his responsibilities included mortgage trading management, fixed income risk management and asset backed lending and worked closely with Mr. Breslauer on several closed and pursued investments. Prior to this, he worked at Salomon Brothers in the research department, and later at the mortgage trading desk. Mr. Kornfeld is a citizen of the United States, a personal friend of Mr. Breslauer and has worked with him for over 25 years.

Jason Meads – Senior Adviser: Mr. Meads has worked closely with Patron since the firm's inception and for the last three years has worked as a part time adviser directly on the asset management of the BV Retail investment (Russia). Mr. Meads was previously a shareholder in a property company in Moscow, Russia, providing development, letting, investment and management services for a number of projects, including the Usadba centre office development (65,000m²) and the Novinsky Bulvar office and retail development (73,000m²). Prior to Stolny Grad, Mr. Meads worked in the U.K. as a portfolio manager for Rugby Estates for three years. He has a Bachelor of Science degree (BSc) in Real Estate Finance from the City University (London). Mr. Meads resides in Jersey. Given his significant experience within the property industry, his direct experience with Patron and his Jersey residence, Mr. Meads will also act as a board member of the General Partner. He is fluent in Russia, German and French and is a citizen of the United Kingdom.

Farhod Moghadam – Senior Adviser (Legal): Mr. Moghadam is a corporate lawyer with over 13 years of legal experience and has worked with Patron for the last 3 years. He has advised a wide variety of public and private enterprises with operations in Europe, the Middle East, Africa, Southeast Asia and North America. His experience has included private equity, joint ventures, M&A, banking and finance and capital markets transactions with an industry sector focus on real estate, hospitality, healthcare, oil & gas and renewable energy. Previously Mr. Moghadam was a senior lawyer at Lawrence Graham where he had spent 8 years in their Corporate Group. Mr. Moghadam holds an honours degree in Law from the University of London (Queen Mary College) and spent a year studying French law at the University of Paris (Panthéon-Assas). Mr. Moghadam speaks Farsi and French to a high level and basic German. He resides in England and is a citizen of the United Kingdom.

Bertrand Schwab – Senior Adviser: Mr. Schwab has worked closely with Patron since the firm's inception and with Mr. Breslauer for the past eighteen years. His primary role includes originating and managing investments for Patron in France. In particular, he led the acquisition of Malakoff, Vectrane and the Hotel Arts, Barcelona. Previously, Mr. Schwab managed a holding company owned by Deutsche Bank, GE Real Estate and JER, which comprised a large French publicly listed company (Bail Investissement) with approximately €2 billion of logistic, retail and office buildings located primarily in France and an asset management company with 150 employees. Before that, Mr. Schwab was Managing Director and Partner of the Deutsche Bank Real Estate Private Equity group. In that position, he led numerous transactions valued at over €4 billion, including the acquisition and management of Filo SA, a publicly listed Spanish shopping centre company, the acquisition of the ISM group and the acquisition of real estate asset portfolios in Italy, Spain, and Portugal. Between 1995 and 1997, he was largely responsible for the development of the real estate franchise of Bankers Trust in France, where he helped develop the distressed loan and asset sale business, leading transactions including the sale of assets for Barclays Bank (where he met Mr. Breslauer and Ms. Langford), UAP, GAN, Credisuez and CDR. Mr. Schwab also advised CDR in the sale of Renta Inmobiliaria, a Spanish property company, the financing of Credit Bail portfolio, and the merger between two large French utility companies: Suez and Lyonnaise des Eaux. Prior to that, he worked at Paribas Capital Markets in London and Tokyo, trading interest rate and currency derivatives. Mr. Schwab is a former board member of Vectrane, Bail Investissement, Selectibanque, Selectibail and Filo – listed companies in France and Spain. He is a graduate of Hautes Etudes Commerciales (HEC), (France), where he majored in Finance. Mr. Schwab resides in England. He is a French citizen and is fluent in French, English and Spanish.

Tim Street – Senior Adviser: Mr. Street has worked closely with Patron since early 2010. His primary responsibilities include originating and managing investments in the real estate backed European Healthcare sector, and with Mr. Kay and Patron co-founded Gracewell Healthcare in 2010. Mr. Street has over 15 years of experience in the European healthcare market during which he has been involved in a number of management buy-outs and over £3.1 billion of successfully completed transactions and developments for investors such as 3i, Goldman Sachs and Allianz Capital Partners. Prior to joining Patron, Mr. Street was a Managing Director at Macquarie Capital Advisers, leading Macquarie's European Healthcare Advisory Services. Mr. Street has held various Board level positions at Westminster Healthcare (acquired by Barchester), Priory and Four Seasons Healthcare. Mr. Street has been directly involved in the management and development of services in the elderly care, mental health, diagnostics and rehabilitation sectors and has developed and led successful commercial relationship with the NHS and Local Authorities. Mr. Street is Chartered Accountant and holds a Master of Business Administration (MBA) degree from Cranfield University – School of Management,

England. He obtained a Bachelor of Business with majors in Accounting, Business Law and Taxation from Queensland University of Technology, Australia. Mr. Street resides in England and is a citizen of Australia.

Georg von Hammerstein – Senior Adviser: Mr. von Hammerstein joined Patron in May 2013 to originate new investments in Germany and German speaking countries and in helping drive exits for the current portfolio. Mr. von Hammerstein has over 25 years of experience in the German and European real estate industry. Prior to Patron, he was at Pramerica Real Estate, the European arm of the US American Prudential Inc., where he spent 14 years, the last 6 years as the European Chief Investment Officer and Chairman of the Investment Committee. He coordinated the transactions for all investment strategies from core to opportunistic for a variety of closed and open ended funds all across Europe including Russia and Turkey. Prior to that Mr. von Hammerstein worked for 5 years with Helaba, responsible for their real estate equity operations. He initiated Helaba's subsidiary for joint venture developments and investments predominantly in Germany. Before that he developed residential properties on own account and held positions in real estate subsidiaries of Commerzbank and of Deutsche Bank/ECE Projektmanagement. Georg holds an MSc degree in economics (Diplom Kaufmann) from WHU Otto Beisheim School of Management, Koblenz and is fluent in English and French. He resides in the UK and in Germany.

Josh Wyatt – Senior Adviser: Mr. Wyatt joined Patron in 2005 and focuses on all aspects of origination, acquisition and management of hospitality sector investments. Since late 2014 Mr. Wyatt spends the majority of his time on the Generator Investment in his role as Chief Strategic Officer and also retains focus on supporting the investment teams in Patron's existing hospitality investments and advising on new opportunities. Prior to joining Patron, he spent seven years in strategy consulting, focusing on financial, operational and property related issues within the Higher Education sector. Initially at Accenture and American Management Systems for three years, Mr. Wyatt subsequently co-founded the Armada Group in 1999, which was later sold in 2003 to Alchemy Ventures in the United Kingdom. Mr. Wyatt holds a BA degree in International Studies and Economics from the American University (Washington DC) and an MBA from Harvard Business School. Mr. Wyatt is a citizen of the United States.



KENTUCKY RETIREMENT SYSTEMS INVESTMENTS



TO: Kentucky Retirement Systems Investment Committee

FROM: Andy Kiehl, Real Assets / Real Estate

DATE: February 2, 2016

SUBJECT: European Real Estate Search Process and Manager Recommendation

Executive Summary

KRS Investment Staff is recommending a €50 million investment in a European Real Estate commingled fund, ***Patron Capital V, L.P.*** to be prorated, according to current percentage allocations for both the pension and insurance fund and the underlying plans. Real Estate investments are funded over a number of years and we further recommend that these dollars be taken from available fund assets whenever capital is called. This Fund will make value added and opportunistic real estate investments in Western Europe. The fee for this investment fund will be a ***1.75% management fee on the commitment amount during the investment period (investment period is 4 years from initial close date) and 1.50% management fee on the aggregate cost of any unrealized investment for the remaining term of the fund (6 years with up to 2-1 year extensions) with a 20% performance fee over a 9% preferred return with a 50% catch-up provision.***

KRS staff has been monitoring and evaluating the European real estate opportunities since early 2015 and we feel that this investment will provide several benefits to our overall real estate portfolio portfolios. First, we expect the investment to return between 17% and 22% gross IRR over a full market cycle net of fees. Secondly, diversification into the developed Western European market with a seasoned management team should help to mitigate risk of international investments. Many of KRS's peers are already invested in European real estate and with Patron Capital including ***Arizona Public Safety Personnel Retirement Systems*** and others.

Patron Capital is a registered investment advisor with the SEC and is also registered with the FCA in the United Kingdom. Patron Capital was founded in 1999 by Mr. Keith Breslaur who is still with the firm. As of January 2016, the firm manages approximately €2.2 billion in assets and has 73 employees in five locations in Europe. The investment team consists of 41 investment professional and senior advisers who are highly skilled in their respective areas of

focus, averaging 18 years experience with the Patron senior partners averaging 23 years of experience.

Real Estate Opportunities in Europe

What is European Real Estate?

The institutional European real estate property types and investment categories are similar to those in the United States. The European managers categorize their properties into Core, Value-Added and Opportunistic investments using similar characteristics as shown below:

- Core – Stabilized, leased properties. Income producing with limited risk.
- Value-Added – Core property types with an identifiable deficiency that can be corrected and converted to core.
- Opportunistic – Similar to Value-Added investments but with greater risk characteristics such as distressed assets, ground up development and vacant land.

U.S. investors seeking to make international investments should also be concerned about systematic risk including political, economic and currency risk. Returns identified by the European managers potentially could be lower (or higher) due to currency fluctuations over the term of the investment. For example, a manager could report a double digit positive return in foreign currency but with the impact of the currency fluctuation, the return in U.S. dollars could be negative.

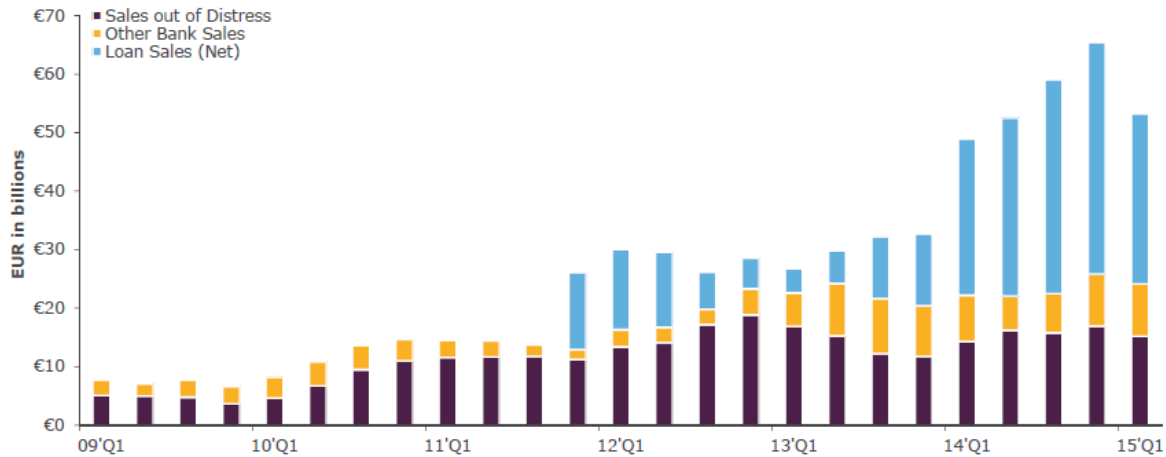
At the institutional level, many real estate managers tend to focus European countries with less economic and political risks. Europe (excluding London) has a much less transparent real estate market compared to the U.S. market. However, many of the U.K., France and Germany funds are very transparent, similar to the U.S. funds. Real estate managers have also begun looking at investments in Spain, Italy and the Nordic Countries as a means to diversify their portfolio outside of the mainstream countries.

Each country has its own unique investing environment so local presence and expertise is critical to the success of the fund.

Why Europe?

Relative to the U.S., Europe has been much slower to recover coming out of the Global Financial Crisis in 2008. Capital values remain below previous peak as Europe is still earlier in the real estate cycle relative to the U.S. Over the next few years, it is expected that many large banks will seek to reduce the real estate holdings on their balance sheets, which should create additional opportunities for real estate transaction. The chart below highlights this point

12 Month Rolling Sales of Balance Sheet Assets in Europe



Source: Real Capital Analytics, July 2015

Conclusion

Due to a historically wide spread between core and non-core assets, ORG feels that value creation provides a very attractive investment thesis and that Value-Added and Opportunistic strategies in the European market are favorable in today's economic environment. The recent strength of the dollar also creates a more attractive entry point to invest in European funds.

ORG cautiously recommend European real estate managers that are experienced in the marketplace and have teams with local knowledge involved in the investment selection and asset monitoring process. The KRS Investment Staff concurs with this investment and selection strategy.

The Search Process

The search process began in early 2015. KRS Investment Staff and ORG Portfolio Management (“ORG”) discussed the European Real Estate opportunities. ORG evaluated the universe of European investment managers and funds included in ORG’s database, which totals over 600 managers that have provided ORG with complete data and over 2,000 investment funds. Of the total database, the European investments totaled 28 managers and 68 investment funds. Managers/funds were eliminated from consideration for a number of reasons, both qualitative and quantitative, reasons include, but were not limited to the following:

- Funds that did not have a team of professionals working together with sufficient track records of investment success through various investment cycles.
- Funds managed by firms with issues such as recent departures, organizational issues or pending sales of the firm.
- Firms that did not provide sufficient information to ORG to evaluate the opportunities.
- Funds/managers that were evaluated in the past three years that failed to sufficiently correct previous concerns.
- Managers who were not transparent and who were unwilling to provide detailed financial, quantitative and qualitative information about their investments, including cash flows, net returns, loan maturities and other pertinent information. ORG deems this information necessary to evaluate past performance and provide sufficient oversight of KRS’ investments.

Based partly on the above criteria, KRS Investment Staff and ORG agreed upon a list of potential candidates. The potential candidates included the following managers/funds:

- Patron Capital – Patron Capital V, L.P.
- Perella Weinberg - Perella Weinberg European Real Estate Fund III, L.P.
- BlackRock – BlackRock Europe Property Fund IV, L.P.
- Kohlberg Kravis Roberts &Co. – KKR Real Estate Partners Europe, L.P.
- Harbert Management Corp. – Harbert European Real Estate Fund IV, L.P.
- Benson Elliot Capital Management– Benson Elliot Real Estate Partners IV, L.P.
- Blackstone – Blackstone Real Estate Partners Europe V, L.P. *

** Initial conversation occurred later in the process due to announcement of fund raising effort.*

Between March and July, KRS Investment Staff and ORG held numerous conference calls with these candidates along with a review of their Private Placement Memorandums (“PPM”), other marketing related materials and prior Detailed Due Diligence Questionnaires (“DDQ”) that had been obtained from several funds. Several firms also visited with the KRS Investment Staff in Frankfurt to review their fund opportunities.

Manager Evaluation Process - Selection of Semi-Finalists

Following the conference calls and review of initial materials, KRS Investment Staff and ORG elected to not pursue the collection of additional information from the following funds, eliminating them from consideration:

- **Benson Elliot**
- **Harbert Management Corp**

ORG issued a DDQ to the following funds to obtain additional, in-depth information regarding their firm and the proposed operations and identifiable risks associated with the investment.

- Kohlberg Kravis Roberts & Co. – KKR Real Estate Partners Europe, L.P.
- Patron Capital – Patron Capital V, L.P. (ORG had a current DDQ on file.)

KRS Investment Staff and ORG independently reviewed responses to the DDQ and other additional documentation provided by the manager.

Finalist Presentations

During November 2015, KRS Investment Staff and ORG held additional in-person interviews with representatives from Patron Capital, KKR and Perella at ORG's office in Cleveland, OH. Topics included discussion on the firm's investment philosophy and process, potential investment opportunity set in light of the firm's expertise in today's current market environment and portfolio construction. There was not an additional in-person interview of BlackRock other than meetings held with the KRS Investment Staff.

ORG had recently met with two of the four finalist candidates at their place of business. A comprehensive due diligence, including an operational review, was conducted at that time. In each instance ORG met with senior firm and investment professionals, research analysts, traders, operations and compliance personnel. (Note: If one of the firms that ORG had not recently visited had been selected, ORG would have performed an on-site visit with that manager prior to the recommendation being finalized.)

Another candidate was dropped for the following reason:

- **Perella Weinberg** - Perella Weinberg European Real Estate Fund III, L.P. – After initial review, KRS Investment Staff and ORG learned that the investment team spun off from Perella Weinberg to form PW Capital. PW Capital had a smaller staff and unproven track record. Also reliance on a single individual within the firm was a concern.

Finalist Selected

KRS Investment Staff and ORG met in Cleveland in January 2016 to discuss the results of the DDQ along with recent firm/fund information. In an in-depth discussion format with KRS and multiple ORG staff each manager was reviewed along with their strengths and weaknesses.

The two managers/funds below were not selected for the following reasons:

- **BlackRock Europe Property Fund IV** – The prior European funds are not considered top-tier performers. The investment focus allows for all property types across all of Europe including Western, Eastern and Central Europe. ORG has observed that fund investments in Eastern and Central Europe generally have not had the same success as fund investments in more stabilized Western Europe.
- **KKR Real Estate Partners Europe IV** – The majority of the key professionals are located in the U.S. as opposed to being on the ground in the target geographies. All of the European professionals (except for one individual) have joined KKR since 2012. Although the team had considerable experience, they had not worked together for a long period. KKR also earns fees from several related party entities which could result in a conflict of interest and above market compensation for the Manager.

At the conclusion of this due diligence, KRS Investment Staff and ORG agreed to recommend Patron Capital V, L.P. Below is a summary of the manager.

About Patron Capital V, L.P.

Firm History & Ownership

Patron was established in 1999 by Keith Breslauer to make value oriented and opportunistic real estate and real estate related investments primarily in Western Europe. Since its founding, Patron has raised over €2.5 billion of equity capital from over 100 primarily institutional investors including sovereign wealth funds, corporate pension plans and endowments across five funds and co-investment pools. As of January 2016, €2.2 billion of equity with over €9 billion of gross asset value has been invested predominately across Western Europe. Patron has operations across Europe with its main advisory offices in the United Kingdom and Luxembourg and additional offices in Germany, Spain and Italy.

Patron's team consists of a total of 73 dedicated professionals led by founder and Managing Director, Keith Breslauer. The team has expertise in acquisitions, asset management, development, finance and operations. Patron's in-house team is supplemented by its extensive network of long standing relationships with local participants, intermediaries, management teams and originators throughout Europe.

Patron's investment team consists of 41 investment professionals and senior advisers (the "Investment Team") who are highly skilled in their respective areas of focus, averaging 18 years

of experience, with the Patron senior partners averaging 23 years of experience. Working on a granular, product and country specific basis, the Investment Team operates effectively as an owner operator and is therefore well positioned to capitalize on investment opportunities that arise as markets throughout Western Europe move through their respective cycles. In addition to the experienced product and country specialists, the Investment Team includes a dedicated in-house development team (the “Development Team”) consisting of four professionals with significant property industry experience who contribute to the underwriting and ensure local partner performance for their respective investments. Patron’s Investment Team has been highly cohesive as a result of low turnover and because many members of the team spent a significant portion of their careers working together either at Patron or with Patron personnel in their previous roles.

Patron’s Investment Team:

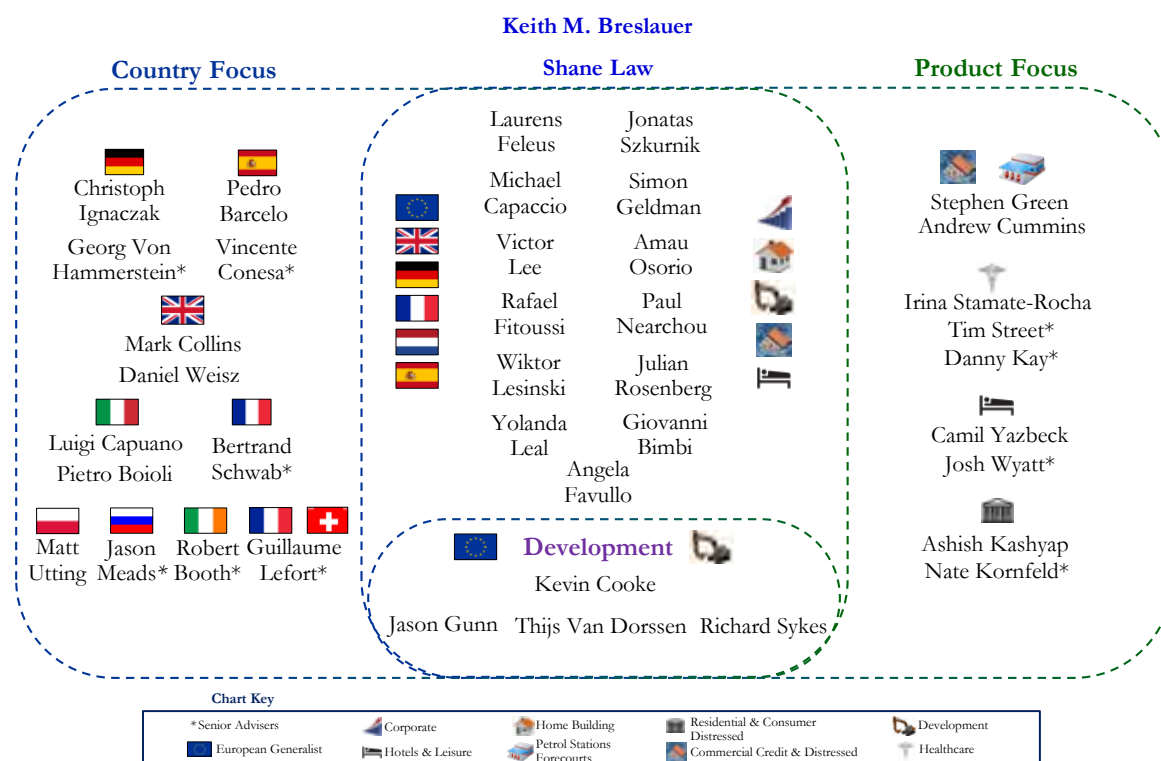


Chart Key

* Senior Advisers	 Corporate	 Home Building	 Residential & Consumer Distressed	 Development
 European Generalist	 Hotels & Leisure	 Petrol Stations	 Commercial Credit & Distressed	 Healthcare
		 Forecourts		

The Investment Team works closely with a 31 person support team (the “Support Team”), which includes key legal, finance and tax, structuring and compliance professionals whose work is instrumental at both the origination stage and during the implementation of business plans. The Support Team also includes a fully staffed Luxembourg organization, which offers a valuable structuring advantage for many of Patron’s investments.

Investment Strategy

The Fund will continue the successful strategy of its predecessor (Fund IV), focusing predominantly on Western Europe, as Patron believes this region remains an attractive investment environment in the near term, which will extend Patron's proven historic performance in the region. The Fund will focus on opportunistic and value oriented investments, primarily targeting distressed and/or undervalued property and property related assets, loans and corporate entities. Specifically, it will target middle market transactions that typically require initial equity commitments in the range of €30 million to €90 million, and in certain cases, will expand to larger commitments based on the respective investment plans. The Fund may also opportunistically invest in attractive larger scale transactions that are consistent with this strategy and meet its risk adjusted return objectives. In these circumstances, the Fund may use co-investment capital from the Fund's investors, in priority, as utilized for relevant investments in prior funds. The Fund will aim to invest in non-competitive situations, originated through Patron's extensive network of long standing relationships with local participants, financial institutions, investment banks, private equity partners, local advisers and agents.

Patron's investments largely fall into four primary strategic themes: distressed, undervalued, non-core and complex, in all cases targeting opportunities with assets that are below fundamental intrinsic value:

Fund Strategic Overview

Distressed <ul style="list-style-type: none">• Bank driven sales/liquidations• Liquidity constrained operators/borrowers/developers	60-70%
Businesses with underlying property below intrinsic asset value <ul style="list-style-type: none">• Asset based expansion with complete entity exit• Companies with strong cash flow supported by underlying real estate assets• Appropriate asset break up and sale with subsequent entity exit or shut down	30-40%
Institutional Non-Core (ex-distressed) <ul style="list-style-type: none">• Property assets below intrinsic value deemed non-core by parent/owner	0-10%
Complex Situations <ul style="list-style-type: none">• Attractive property fundamentals encumbered by complex situations	0-5%

Within the four primary themes, Patron identifies granular micro themes, including specific asset subcategories and geographic markets, in which these features and other attractive market dynamics are most prevalent and where the benefit of Patron's depth and breadth of experience can be brought to bear most effectively. Given the dislocated economic and market environment, Patron expects to capitalize on such pockets of opportunity across Western Europe over the near term. Examples of primary micro themes for focus are:

Primary Micro Themes

- **Commercial Bank and Financial Institution Inventories:** European financial institutions have large portfolios of distressed commercial real estate loans and foreclosed real estate assets on their balance sheets that are considered non-core and have prioritized the need to liquidate the positions with increased urgency.
- **Liquidity Constrained Opportunistic Partners:** Opportunistic local partners that have identified opportunities but lack the necessary capital, given reduced local leverage.
- **Distressed and Overleveraged Developer/Investors:** Developers and investors that have come under pressure to liquidate assets due to overleveraging.
- **Public and Private Asset Rich Corporates with Liquidity Problems:** Such companies are typically capital constrained either due to lack of financing available in the debt markets or the limited capital of their founding sponsors.
- **Dislocated Mortgage Markets (residential and commercial) and Defaulted Securitized Assets:** Acquisition of portfolios, performing and non-performing as well as participating in certain mortgage backed loans and related opportunities.

Patron believes that its established platform as a pan-European opportunistic real estate investor, with experience and expertise in analyzing and underwriting diverse real estate assets in multiple geographies, its granular asset focus, local asset management capabilities and its ability to address complex corporate related issues, makes Patron ideally positioned to properly underwrite and capitalize on the current and anticipated deal flow.

Market Conditions and Risk Management

(Following are comments from Patron's DDQ responses.)

Patron believes the current market conditions create an attractive investment environment for the Fund's strategy.

The Fund will primarily target investments in Western Europe, with a focus on the UK, Germany, Spain, Ireland, the Netherlands, France and Italy. The overall economy in Europe is beginning to stabilize, supported by increased liquidity, reduced unemployment and improvements in manufacturing and GDP, with growth in the EU estimated at 1.3% for 2014 and 1.5% forecast for 2015, up from zero growth in 2013. The European Central Bank is now firmly behind driving the recovery with the recent announcement of an approximate €1.1 trillion of support. Patron believes the key opportunities are driven by deleveraging in European banks, related direct and indirect asset sales and reduced lending by traditional financial institutions to local market participants in reaction to changes in the regulatory environment. These significant shifts within the financial institutions, combined with limited

new supply in key European markets due to a general lack of new construction have, in Patron's view, created attractive potential upside for property assets. Further, the increasing hunt for yield by both domestic and international investors has driven strong demand for institutional-quality assets. Patron sees a compelling opportunity in this environment to acquire and improve difficult and challenged assets and exit into what Patron expects to be an increasingly stable and liquid market. In summary:

- (a) Macroeconomic Environment: Europe's macro market is slowly stabilizing and improving as a result of low rates, falling commodity prices and improving liquidity;
- (b) Property Trends: Key European cities have experienced minimal development over the last seven years, which Patron believes has created attractive upside for existing property assets; and
- (c) Deleveraging Opportunity: Continued deleveraging by banks, maturing debt and an increasingly restrictive regulatory environment within the next few years will continue to drive non-core asset sales

Patron believes these trends create attractive conditions to source and execute investments with strong absolute and risk-adjusted return potential over the Fund's investment period. There is a significant opportunity in Western Europe's fragmented and supply-constrained markets for Patron, as an owner-operator with regional and cross-sector expertise, to acquire assets and companies below intrinsic value and execute value-add business plans with relatively shorter investment duration. These opportunities for a group like Patron are largely driven by a lack of transparency within the financial institution sector and Patron's granular knowledge built up over 20+ years by the key principals.

Over the past four years, Patron has seen an increasing number of opportunities driven by the continued deleveraging of the banking sector, an improved interest rate environment and a slow return to economic growth across most European markets. In the past two years, and as expected over the next two to four years, the majority of the opportunities have a large component of cash flow and a generally shorter duration with respect to their investment horizon. This is a significant improvement in the investment environment relative to the 2005 to 2007 period which impacted Fund II and Fund III. Specifically over the last 12 months Patron has evaluated and spent significant time on over 300+ opportunities representing over \$16.5 billion of capital.

The market conditions that would be the most challenging for Patron V would be a significant increase in interest rates without a corresponding rise in economic activity. The effect of this increased rate environment would put severe pressure on consumers across Europe, given the generally high levels of leverage that still exist and thereby impact consumer spending. This would in turn provide a significant headwind to the current recovery in key European countries and may lead to a recessionary environment. However, Patron would anticipate that any rise in rates would be alongside an increase in economic activity.

Another concern would be some event that would impact liquidity to the European

environment. Patron considers this to be quite a crucial issue, as liquidity has returned to the system and although it is still in its nascence it has momentum. It is generally believed that the lack of liquidity and leverage by the banks was one of the primary causes for the continued weakness of the European economy.

Various further key risks, should they occur, may negatively impact the European recovery and the perceived positive tailwind, and in turn the investment strategy. These include:

- Change in political power across key economic participants (i.e. Greece change of government, UK's May election). The recent referendum for Scottish devolution may further inspire other independent movements (i.e. Catalan) happening across Europe
- Central banks / governments make a policy mistake with monetary policy (rates) and/or fiscal policy (taxes) as economies improve
- China credit implodes and severely impacts global GDP and liquidity
- War – Russia to W. Ukraine / Poland – Boycott of imports and impact on European economy.

Patron has always practiced a cautious position with respect to leverage. Specifically, if Patron could not have confidence that they are receiving the right provisions, they would not borrow the money. This way Patron always maintains control of the financing and therefore effectively use leverage as a form of tail risk protection. The targeted leverage is approximately 55%-60% but historically on average has been as low as 33% when Patron became concerned with the market conditions.

Additionally, Patron believes its current geographic focus on Western Europe markets is important in mitigating the potential impact of sub-optimal economic conditions. This is supported by the current Fund IV focus and the lessons learned from both Fund II and III where portfolio performance was impacted by poorer performing investments in Central and Eastern Europe (see below table). Fund V will continue the successful strategy of Fund IV, focusing predominantly on Western Europe given the compelling opportunities and Patron's proven investment performance in the region.

Overall, Patron's Western European performance has surpassed expectations throughout overall market cycle via a mix of property backed investments with operational elements and direct property investments combined with downside protection using lower leverage.

Patron Overall Performance as of September 30, 2015 (€ in millions)

	<i>Number of Investments</i>	<i>Invested & Identified Equity ⁽ⁱⁱ⁾</i>	<i>Realised Proceeds ⁽ⁱⁱⁱ⁾</i>	<i>Unrealised Proceeds ^(iv)</i>	<i>Realised & Unrealised Proceeds ^(v)</i>	<i>LTV ^(vi)</i>	<i>Gross IRR ^(vii)</i>	<i>Gross Equity Multiple ^(viii)</i>
Overall Patron Performance	61	€2,195m	€1,264m	€2,250m	€3,514m	40.7%	16%	1.60x
Western Europe	53	€1,876m	€1,230m	€2,054m	€3,284m	38.3%	21%	1.75x

In addition, Patron views portfolio management as a dynamic process, as each new investment will change the Fund's portfolio characteristics and must be evaluated within this context and not only as a stand-alone investment. Therefore Patron reviews each investment in the context of the entire portfolio, evaluating its contribution to the Fund's diversification, risk profile, currency exposure, leverage dynamics and return objective.

Accounting, Compliance and Legal

Patron stated it has a detailed monitoring program. The General Counsel, as Compliance Officer and MLRO (Money Laundering Reporting Officer) ensures monitoring program is followed and MLRO policy is complied with. The Monitoring Program is managed by the Compliance Officer and reviewed on an annual basis by external advisors.

In addition, quarterly, half yearly and annual reports to the board of Patron are produced in relation to many aspects of compliance which also includes training programs. Considerable time has been spent on this structure with legal advisers, King & Wood Mallesons LLP (previously SJ Berwin LLP).

In addition, the Fund's Jersey Administrator will be responsible for ensuring that all prospective investors in the Fund satisfy the applicable money laundering requirements and the Fund's investment activities are in accordance with Jersey regulatory requirements.

Performance

The overall performance of the prior Patron funds is shown in the table above. Fund V is targeting a 17-22% gross IRR with a 1.7x gross equity multiple.

Management Fees

The management fee for this investment fund will be a 1.75% fee per annum on commitment capital during the investment period (4 years) and 1.5% fee on the aggregated acquisition cost of any unrealized investments after the investment period with a 20% performance fee over a 9% preferred return with a catch-up provision. The fund will employ leverage with a loan-to-value limit of 65% for the total fund with a limit of 75% on any one investment.

Summary

KRS staff is recommending an investment in Patron Capital V, L.P. for both the pension and insurance funds. The recommended investment of €50 million will be split to the pension fund and to the insurance fund. Staff expects this investment to earn between 17% and 22% gross of all fees, with minimal leverage for the strategy and offer excellent diversification benefits to the overall portfolio.

Biographies of Key Patron Professionals, Investment Team and Senior Advisers

Keith M. Breslauer – Managing Director & Senior Partner: Mr. Breslauer founded Patron Capital in 1999 and is the Managing Director of Patron Capital Advisers LLP (and held a similar position in its predecessor vehicles), the investment adviser to the Patron Capital Funds (including Patron Capital Captive Fund, Funds I - IV). In addition to his overall leadership responsibility, Mr. Breslauer is primarily responsible for leading the origination efforts of all Patron funds.

Mr. Breslauer began his career in 1988 at Lehman Brothers, where he worked originally in the Financial Institutions Group in partnership with the Mortgage Trading Group. In addition to various responsibilities related to corporate finance and capital markets, he was involved in and led many transactions in the United States distressed markets of the 1980s and 1990s. In 1993, while with Lehman Brothers, Mr. Breslauer moved to London to target distressed assets in Europe and to assist in the creation and leadership of the Principal Finance Group, established to invest Lehman Brothers' capital in financial institutions and property assets and companies. He also served as the co-head of the International Mortgage and Real Estate Department until 1997. In 1997, Mr. Breslauer left Lehman Brothers to create and manage an investment fund focusing on smaller European property opportunities. As a bridge to the ultimate formation of Patron, he established and managed Capstar Holdings Limited, a company organized in London to originate investments on an exclusive basis for the Lone Star Opportunity Fund (I), a primarily United States based real estate fund.

Mr. Breslauer's background includes numerous investments in both property and mortgage assets and operation businesses (including hotels, servicing businesses and mortgage institutions), on a pan-European basis. He has led or assisted in the acquisition of over \$20 billion in assets in several European countries and in the United States. Additionally, he has broad experience in corporate transactions ranging from mergers and acquisitions to equity and debt capital raising and structured finance.

He holds a Master of Business Administration (MBA) degree from the University of Chicago and a Bachelor of Science (BSc) degree from the New York University School of Business. Mr. Breslauer has resided in London for the past twenty-one years with his wife and four children and is a citizen of the United States.

Shane Law – Chief Operating Officer & Senior Partner: Mr. Law formally joined Patron in 2003, after working closely with Patron since 2000 on the Fund I, Simon Storage investment in his role as investment banker at Commerzbank Securities, Patron's adviser on that transaction. Mr. Law's COO responsibilities primarily include managing the day-to-day operations of Patron, oversight and support to the Patron team across all investments and processes, investor related matters and recruitment and overall support to the Investment Team. In addition to his COO role, Mr. Law focuses on Patron's corporate investments and related responsibilities. Prior to joining Patron, he spent six years in investment banking focusing on European mergers and

acquisitions, initially at Svenska Handelsbanken and subsequently at Commerzbank Securities. He began his professional career at Ernst & Young (London), where he spent three years as a chartered accountant. Mr. Law holds a Bachelor of Science (BSc) degree in Mathematics from the University of Durham and he is a qualified Chartered Accountant (ACA). Mr. Law resides in England and is a citizen of the United Kingdom.

Investment Team

Mark Collins – Chairman of UK Investments & Senior Partner: Mr. Collins joined Patron in 2012 with a focus on the UK real estate market. Mr. Collins has extensive experience in the property industry, including several main Board roles and most recently as Managing Director of Lloyds Bank Corporate Real Estate Business Support Unit. Prior to this, he was COO at the UK's largest property company, Land Securities Group PLC, Managing Director for UK and Europe at GE Capital Real Estate and Assistant General Manager of Property Advisory at Sumitomo Bank. Mr. Collins knowledge of the UK's property industry, high profile firms and their CEO's has been extremely beneficial for Patron in establishing new relationships and investment opportunities. In addition given his extensive experience across various company boards and corporate governance related matters, Mr. Collins currently acts in a personal capacity as Chairman on both the Generator and CALA homes Investments within Fund III and Fund IV respectively. Mr. Collins also has extensive experience at the operational and transactional levels. He was responsible for managing major change initiatives at Land Securities and on the transactional side, he was instrumental in putting together a number a number of significant property deals, including leading the first ever corporate acquisition for Land Securities of TOPS Estates PLC and creating a £540m Joint Venture with British Land. He also originated the largest ever real estate take private deal in Europe with MEPC in 2000. Mr. Collins is a chartered surveyor by training and holds a Bachelor of Science (BSc) degree in valuation and real estate management from University of West England. Mr. Collins resides in England and is a citizen of the United Kingdom.

Stephen Green – Senior Partner, Special Situations: Mr. Green joined Patron in 2009 as a Senior Partner responsible for special situations, including the origination and underwriting of real estate debt related investments, restructurings, and complex corporate opportunities. Prior to joining Patron, Mr. Green worked at Merrill Lynch for 12 years, for much of this time as Managing Director and from 2000 as Head of the Merrill Lynch European Commercial Real Estate Finance business, which covered investment property and operating real estate loan origination, underwriting, syndication and securitization. In addition to personally leading many of that group's larger transactions, Mr. Green was responsible for the overall activities of a team of 55 professionals in London, Frankfurt and Milan. Prior to joining Merrill Lynch in 1997, Mr. Green worked for 4 years with Mr. Breslauer in the real estate team at Lehman Brothers. Mr. Green holds a Bachelor of Arts ("BA") (Hons) in Physics from Oxford University and qualified as a Chartered Accountant with Ernst & Young before joining Lehman Brothers. Mr. Green lives in London and is a citizen of the United Kingdom.

Pedro Barcelo – Managing Director & Senior Partner, Spain: Mr. Barcelo is responsible for

the management of Patron's office in Barcelona and has responsibility for the origination, due diligence, execution, structuring, financing and asset management of investments in Spain. Mr. Barcelo formally joined Patron in 2004, after working with Patron during that year on the refinancing of the Hotel Arts in his role as loan originator at Hypo Real Estate Bank International. Mr. Barcelo spent three years at Hypo Real Estate Bank International focusing on project & corporate loan origination, initially in London and subsequently in Madrid. Previously, Mr. Barcelo worked for one year at Enron in the underwriting department in London and also worked for two years at Hines in the development of the Diagonal Mar mixed use project in Barcelona. Mr. Barcelo holds a degree in Civil Engineering from the Polytechnic University of Catalonia and a MBA degree from IESE (Barcelona). He speaks Spanish, Catalan and English, resides in Barcelona and is a citizen of Spain.

Luigi Capuano – Managing Director & Chairman, Italy: Mr. Capuano formally became an advisor to Patron in June 2006, with an initial focus on institutional banking relationships. In 2010, he assumed day-to-day management of the Patron Italy team, with responsibility for new business and the management of existing investments. Prior to joining Patron, Mr. Capuano spent most of his professional career in the Italian banking system where, from 1990, he held senior management positions including General Director of San Paolo di Torino, Chief Executive of Banca Popolare di Novara, Chief Executive of Italfondinario, and Group Head of the Italian Bank Division of Bank Group Banca Intesa. Mr. Capuano holds a Degree in Jurisprudence from the University of Turin. He is the President of the National Tax Collectors Syndicate and of SITEBA (Bank Technology Systems). He is also a member of the Management Board of various commercial and service companies and is a member of the National Auditors Register. Mr. Capuano is a citizen of Italy and speaks Italian and English.

Laurens Feleus – Investment Director & Senior Partner: Mr. Feleus joined Patron in January 2005 and focuses on investments in the Benelux and Nordic countries. He also focuses on Patron's activities in residential real estate and financial institutions and is responsible for Patron's activities on behalf of certain investors in India. Mr. Feleus started his career in investment banking at Salomon Smith Barney (now Citigroup Investment Bank) in London in 2000. Before joining Patron, he also worked for a privately owned United Kingdom/Swiss based investment banking boutique specializing on medium sized private equity deals. He holds a Master of Arts in Financial Economics from the University of Amsterdam. He is fluent in English, German, Dutch (Flemish) and French. Mr. Feleus resides in England and is a citizen of The Netherlands.

Christoph Ignaczak – Investment Director & Senior Partner, Germany: Mr. Ignaczak joined Patron in 2012 and focuses on German investments, with responsibilities including origination, due diligence, execution, asset management and business plan implementation. Prior to joining Patron, Mr. Ignaczak worked at Acrest Property Group, a real estate development and asset management company based in Berlin, Germany, as Director where he was primarily in charge of financing and investment analysis. Previously, Mr. Ignaczak worked for more than 4 years in the real estate finance team at Merrill Lynch and started his career at Eurohypo. Mr. Ignaczak graduated from the University of Cologne with a Business Administration Degree and is CFA

charterholder. Mr. Ignaczak is fluent in English and German. Mr. Ignaczak resides in England and is a citizen of Germany.

Jonatas Szkurnik – Investment Director & Senior Partner: Mr. Szkurnik joined Patron in August 2007. Mr. Szkurnik focuses on Patron's direct investments in real estate, asset backed operating companies and corporate investments, with responsibilities including deal sourcing, execution, structuring, financing, due diligence and asset management. To date, Mr. Szkurnik has been involved in investments in residential, commercial and healthcare sectors, amongst others. Mr. Szkurnik started his career in Brazil in investment banking and holds a BSc in Civil and Industrial Engineering from Pontificia Universidade Catolica (PUC-Rio) and a MBA from London Business School. He is fluent in English, Spanish and Portuguese. Mr. Szkurnik is a citizen of Brazil.

Daniel Weisz – Investment Director & Senior Partner: Mr. Weisz joined Patron in August 2006 and focuses on Patron's principally commercial real estate investments in the UK and France, including direct real estate and asset backed operating companies, with responsibilities including origination, execution and asset management. Prior to joining Patron, Mr. Weisz's career included investment banking focused on Alternative assets investment advisory at JP Morgan, alternate assets fund and equity placement, and direct European real estate and real estate related investment. He holds a BSc in Accounting and Finance from the London School of Economics. Mr. Weisz is fluent in French and Hebrew and resides in England.

Michael Capaccio – Investment Director & Senior Partner: Mr. Capaccio joined Patron in 2004 in the role of senior originator and asset manager for new investments in Romania and Italy. Mr. Capaccio was previously with Lehman Brothers in the United Kingdom and Italy, where he was co-head of the Italian real estate principal business. During his five year tenure with Lehman Brothers, Mr. Capaccio originated or was involved as a senior manager in more than €3 billion of equity, mezzanine and senior debt investments in Italy, France and Central Europe. He began his professional career at Bankers Trust Company in New York and Chicago and has over 30 years of experience in property investment, finance and development in the US and Europe. Mr. Capaccio holds a BA degree cum laude in Economics and Political Science from Rutgers University. Mr. Capaccio resides in Italy. He speaks English, Italian and French and is a United States citizen.

Ashish Kashyap – Investment Director: Mr. Kashyap joined Patron in March 2009 and focuses on Patron's investments in residential real estate debt, consumer debt and financial institutions. Prior to joining Patron, he spent two years at Merrill Lynch's structured finance group in London, where he was responsible for analytics for the group's residential real estate investments. He also has five years' experience through various operational roles at Capital One in the United States. Mr. Kashyap holds a Bachelor of Technology (B Tech) degree in Computer Science and Engineering from the Indian Institute of Technology (India) and a Masters of Business Administration (MBA) degree from Insead (France and Singapore). Mr. Kashyap resides in England and is a citizen of the United Kingdom.

Matthew Utting – Investment Director: Mr. Utting joined Patron in 2000 and has primary

responsibility for all investments in Poland. He worked previously in various analytical positions for Bank of Nova Scotia, Citibank and Bank of Montreal. Mr. Utting holds a Master of Arts degree ("MA") in Economics and a BA with honours in Economics (Applied Studies) from the University of Waterloo. Mr. Utting resides in England, is fluent in French and conversationally proficient in Spanish, Italian and German and is a citizen of the United Kingdom and Canada.

Camil Yazbeck – Investment Director, Hospitality: Mr. Yazbeck leads all aspects of origination, acquisition, underwriting, execution and asset management of new investment opportunities as well as the strategic and operational management of assets in Patron's hospitality sector investments. Prior to joining Patron, he spent over 20 years in the hospitality industry, focusing on all aspects of hotel operations in a variety of roles throughout the world. He held several senior positions with international hotel companies, including Operations Director, Group and Area General Manager. He acquired extensive experience moving up the ranks in hotel operations, in hotel pre-openings as well as the extended stay hotel market, within independent and branded hotels including Le Meridien, Crowne Plaza, Holiday Inn, Mercure, Best Western, The Ascott Group, Citadines and Staybridge Suites. Mr. Yazbeck holds a Master of Business Administration (MBA) specialized in Hospitality Management from IMHI: Institut de Management Hôtelier International (A joint program of Cornell University (USA) and ESSEC Graduate School of Management, Paris, France), and a French BTS (Bachelor equivalent) in Hotel and Restaurant Management from the Lycée Hôtelier Château Bellerive (Grenoble Academy, Vienne, France). Mr. Yazbeck resides in England and is a citizen of France.

Andrew Cummins – Vice President, Special Situations: Mr. Cummins joined Patron's Investment Team in 2011 and focusses on investment across Europe, particularly the UK and Nordic Countries. Mr. Cummins is responsible for deal sourcing, execution, structuring, financing, due diligence, asset management and business plan implementation, with an emphasis on special situations, including real estate debt related investments, restructurings, and complex corporate opportunities. Prior to joining the Investment Team, Mr. Cummins trained as a Barrister, during which time he worked part-time in Patron's in-house legal department. Mr. Cummins was educated at the University of Edinburgh (Master of Arts (Honours), majoring in Politics and Economics; Master of Science in European and International Relations), City University (Graduate Diploma in Law) and the Inns of Court School of Law (Bar Vocational Course, Postgraduate Diploma in Professional Legal Skills). Mr. Cummins resides in England, is proficient in Swedish and is a citizen of the United Kingdom.

Simon Geldmann – Vice President: Mr. Geldmann joined Patron in 2007 working part-time during his university studies and joined full-time after graduating in 2010. Mr. Geldmann focuses on Patron's German activities with responsibilities including origination, execution, structuring, financing, due diligence and asset management. To date, Mr. Geldmann has been involved in investments across most asset classes in Germany as well as in the healthcare sector in the UK. Prior to joining Patron Mr. Geldmann worked as an intern in the shipping and property industries in China and Germany. Mr. Geldmann holds a Bachelor of Arts degree with honours in Business Management from the University of Westminster. He is fluent in English and German. Mr. Geldmann resides in England and is a German citizen.

Victor Lee – Vice President: Mr. Lee joined Patron in August 2008 and focuses primarily on UK investments with responsibilities including origination, due diligence, execution, structuring, financing and asset management. Prior to joining Patron, Mr. Lee attained a Bachelor of Arts degree with honours in History from Oxford Brookes University. Mr. Lee resides in England. He is proficient in French and is a citizen of the United Kingdom and the United States.

Irina Stamate-Rocha – Vice President: Ms. Stamate-Rocha joined Patron in 2011, with responsibilities in deal sourcing, execution, structuring, financing, due diligence and asset management of healthcare related investment opportunities. Prior to joining Patron, Ms. Irina Stamate-Rocha worked in investment banking at Rothschild, Macquarie Capital Advisers and Fortis Bank (Brussels). Her experience includes the origination and execution of transactions for private equity and infrastructure funds. Ms. Stamate-Rocha holds a Masters in Finance degree from Vlerick Leuven Gent Management School and she obtained a Bachelor in Economics from the Academy of Economics, Bucharest. Ms. Stamate-Rocha resides in England and is a citizen of Romania.

Senior Advisers

Senior advisers are senior expert independent individuals who provide services to and/or invest directly into the portfolio companies and are remunerated directly by portfolio companies or the Partnership.

Robert Booth – Senior Adviser: Mr. Booth has worked with Patron since 2007 when he began working on a joint venture with Patron through Capital Park in Warsaw. Since early 2008 Mr. Booth's primary responsibilities have been the origination and management of investments for Patron in Ireland, with a focus on distressed assets and businesses and utilizing his substantial relationships within the banking sector. Prior to working with Patron, from 2001 to 2007 Mr. Booth worked in the data centre industry where he was founder and CEO of Global Voice Networks, working in conjunction with Hewlett Packard Corporation to market data centre and outsourcing services to corporate tenants such as Google, Amazon, Microsoft, Bank of Ireland and Hutchison Whampoa. Prior to 2001, Mr. Booth established Trinity Group Limited, one of Ireland's largest computer resellers. The company, which had 45 staff and revenues of £25 million (Irish pounds), sold products on behalf of HP, Compaq, Sun, Oracle and Microsoft. He was also involved in the establishment of Trinity Commerce, an e-commerce development company which was primarily sold to Eircom. Mr Booth holds a Bachelor of Commerce Degree from University College Dublin. Mr Booth resides in Dublin and is a citizen of Ireland.

Daniel Cohn – Senior Adviser (Legal): Mr. Cohn is a corporate finance lawyer with over 15 years of experience and has worked with Patron for the last 9 years. Mr. Cohn has led large scale corporate and real estate transactions and managed teams of lawyers and other professionals in all major European jurisdictions. His range of experience includes real estate, private equity, banking and finance, M&A, MBOs & LBOs, public markets, public-to-private and joint venture transactions in multiple industry sectors across Europe. Prior to working with

Patron, Mr Cohn was a senior lawyer with Berwin Leighton Paisner where he had been focusing on large scale corporate property and principal finance transactions for major United Kingdom banks and private equity funds. Mr. Cohn holds an MA in Political Science and European Law from Johann Wolfgang Goethe University, Frankfurt. He studied law in Manchester. Mr. Cohn speaks Hebrew and German fluently, resides in England and is a citizen of Germany.

Daniel Kay – Senior Adviser: Mr. Kay has worked closely with Patron since 2008. His primary responsibilities include originating and managing investments for Patron in the real estate backed European Healthcare sector, and with Mr. Street and Patron co-founded Gracewell Healthcare in 2010. Mr Kay spent the early part of his career at Citicorp Investment Bank, later moving to HSBC working within its property finance division. In 1997 he joined Lend Lease Corporation as a Principal within its Private Equity division making real estate related investments including healthcare related joint ventures. He subsequently joined Trizec Hahn Europe, and then established a joint venture with Safeland plc, to develop a self-storage business in Italy. In 2003, through DKS Trading Limited, Mr. Kay identified and was responsible for the acquisition of Ten Harley Street Limited, a business providing flexible accommodation and services to medical practitioners through a freehold building in London's Harley Street. In 2007, in partnership with management, Mr. Kay negotiated, structured and closed the MBO of Medical Direct Group plc, one of the United Kingdom's leading providers of medical services to the United Kingdom life insurance sector, bringing in Investec Bank as a lead investor in the MBO. The business was sold to Capita plc in 2012. Mr. Kay remains a non-executive director of DKS Trading. He has BSc from the London School of Economics and resides in England and is a citizen of the United Kingdom.

Nathan ("Nate") Kornfeld – Senior Adviser: In the last eight years, Mr. Kornfeld has taken on a more active role within Patron, advising the firm's activities in residential mortgage backed investments, including the UK Residential Distressed Program. Mr. Kornfeld was President of GMAC Institutional Advisors, a \$14 billion investment management company specializing in commercial real estate at GMAC Commercial Mortgage (now Capmark) until 2005. He previously spent two years at GMAC-RFC, where he established the GMAC Venture Capital Fund to invest in residential mortgage technology companies. Mr. Kornfeld had previously founded the Phoenix Finance Group, a specialty finance company that acquired and collected delinquent credit card debt and was subsequently sold to GMAC in 1998. Between 1987 and 1996, Mr. Kornfeld worked as a managing director at Lehman Brothers, where his responsibilities included mortgage trading management, fixed income risk management and asset backed lending and worked closely with Mr. Breslauer on several closed and pursued investments. Prior to this, he worked at Salomon Brothers in the research department, and later at the mortgage trading desk. Mr. Kornfeld is a citizen of the United States, a personal friend of Mr. Breslauer and has worked with him for over 25 years.

Jason Meads – Senior Adviser: Mr. Meads has worked closely with Patron since the firm's inception and for the last three years has worked as a part time adviser directly on the asset management of the BV Retail investment (Russia). Mr. Meads was previously a shareholder in a property company in Moscow, Russia, providing development, letting, investment and

management services for a number of projects, including the Usadba centre office development (65,000m²) and the Novinsky Bulvar office and retail development (73,000m²). Prior to Stolny Grad, Mr. Meads worked in the U.K. as a portfolio manager for Rugby Estates for three years. He has a Bachelor of Science degree (BSc) in Real Estate Finance from the City University (London). Mr. Meads resides in Jersey. Given his significant experience within the property industry, his direct experience with Patron and his Jersey residence, Mr. Meads will also act as a board member of the General Partner. He is fluent in Russian, German and French and is a citizen of the United Kingdom.

Farhod Moghadam – Senior Adviser (Legal): Mr. Moghadam is a corporate lawyer with over 13 years of legal experience and has worked with Patron for the last 3 years. He has advised a wide variety of public and private enterprises with operations in Europe, the Middle East, Africa, Southeast Asia and North America. His experience has included private equity, joint ventures, M&A, banking and finance and capital markets transactions with an industry sector focus on real estate, hospitality, healthcare, oil & gas and renewable energy. Previously Mr. Moghadam was a senior lawyer at Lawrence Graham where he had spent 8 years in their Corporate Group. Mr. Moghadam holds an honours degree in Law from the University of London (Queen Mary College) and spent a year studying French law at the University of Paris (Panthéon-Assas). Mr. Moghadam speaks Farsi and French to a high level and basic German. He resides in England and is a citizen of the United Kingdom.

Bertrand Schwab – Senior Adviser: Mr. Schwab has worked closely with Patron since the firm's inception and with Mr. Breslauer for the past eighteen years. His primary role includes originating and managing investments for Patron in France. In particular, he led the acquisition of Malakoff, Vectrane and the Hotel Arts, Barcelona. Previously, Mr. Schwab managed a holding company owned by Deutsche Bank, GE Real Estate and JER, which comprised a large French publicly listed company (Bail Investissement) with approximately €2 billion of logistic, retail and office buildings located primarily in France and an asset management company with 150 employees. Before that, Mr. Schwab was Managing Director and Partner of the Deutsche Bank Real Estate Private Equity group. In that position, he led numerous transactions valued at over €4 billion, including the acquisition and management of Filo SA, a publicly listed Spanish shopping centre company, the acquisition of the ISM group and the acquisition of real estate asset portfolios in Italy, Spain, and Portugal. Between 1995 and 1997, he was largely responsible for the development of the real estate franchise of Bankers Trust in France, where he helped develop the distressed loan and asset sale business, leading transactions including the sale of assets for Barclays Bank (where he met Mr. Breslauer and Ms. Langford), UAP, GAN, Credisuez and CDR. Mr. Schwab also advised CDR in the sale of Renta Inmobiliaria, a Spanish property company, the financing of Credit Bail portfolio, and the merger between two large French utility companies: Suez and Lyonnaise des Eaux. Prior to that, he worked at Paribas Capital Markets in London and Tokyo, trading interest rate and currency derivatives. Mr. Schwab is a former board member of Vectrane, Bail Investissement, Selectibanque, Selectibail and Filo – listed companies in France and Spain. He is a graduate of Hautes Etudes Commerciales (HEC), (France), where he majored in Finance. Mr. Schwab resides in England. He is a French citizen and is fluent in French, English and Spanish.

Tim Street – Senior Adviser: Mr. Street has worked closely with Patron since early 2010. His primary responsibilities include originating and managing investments in the real estate backed European Healthcare sector, and with Mr. Kay and Patron co-founded Gracewell Healthcare in 2010. Mr. Street has over 15 years of experience in the European healthcare market during which he has been involved in a number of management buy-outs and over £3.1 billion of successfully completed transactions and developments for investors such as 3i, Goldman Sachs and Allianz Capital Partners. Prior to joining Patron, Mr. Street was a Managing Director at Macquarie Capital Advisers, leading Macquarie’s European Healthcare Advisory Services. Mr. Street has held various Board level positions at Westminster Healthcare (acquired by Barchester), Priory and Four Seasons Healthcare. Mr. Street has been directly involved in the management and development of services in the elderly care, mental health, diagnostics and rehabilitation sectors and has developed and led successful commercial relationship with the NHS and Local Authorities. Mr. Street is Chartered Accountant and holds a Master of Business Administration (MBA) degree from Cranfield University – School of Management, England. He obtained a Bachelor of Business with majors in Accounting, Business Law and Taxation from Queensland University of Technology, Australia. Mr. Street resides in England and is a citizen of Australia.

Georg von Hammerstein – Senior Adviser: Mr. von Hammerstein joined Patron in May 2013 to originate new investments in Germany and German speaking countries and in helping drive exits for the current portfolio. Mr. von Hammerstein has over 25 years of experience in the German and European real estate industry. Prior to Patron, he was at Pramerica Real Estate, the European arm of the US American Prudential Inc., where he spent 14 years, the last 6 years as the European Chief Investment Officer and Chairman of the Investment Committee. He coordinated the transactions for all investment strategies from core to opportunistic for a variety of closed and open ended funds all across Europe including Russia and Turkey. Prior to that Mr. von Hammerstein worked for 5 years with Helaba, responsible for their real estate equity operations. He initiated Helaba’s subsidiary for joint venture developments and investments predominantly in Germany. Before that he developed residential properties on own account and held positions in real estate subsidiaries of Commerzbank and of Deutsche Bank/ECE Projektmanagement. Georg holds a MSc degree in economics (Diplom Kaufmann) from WHU Otto Beisheim School of Management, Koblenz and is fluent in English and French. He resides in the UK and in Germany.

Josh Wyatt – Senior Adviser: Mr. Wyatt joined Patron in 2005 and focuses on all aspects of origination, acquisition and management of hospitality sector investments. Since late 2014 Mr. Wyatt spends the majority of his time on the Generator Investment in his role as Chief Strategic Officer and also retains focus on supporting the investment teams in Patron’s existing hospitality investments and advising on new opportunities. Prior to joining Patron, he spent seven years in strategy consulting, focusing on financial, operational and property related issues within the Higher Education sector. Initially at Accenture and American Management Systems for three years, Mr. Wyatt subsequently co-founded the Armada Group in 1999, which was later sold in 2003 to Alchemy Ventures in the United Kingdom. Mr. Wyatt holds a BA degree in

International Studies and Economics from the American University (Washington DC) and an MBA from Harvard Business School. Mr. Wyatt is a citizen of the United States.



Kentucky Retirement Systems

Statement of Disclosure and Placement Agents – Manager Questionnaire

1. Did your firm use a placement agent as defined in the KRS “Statement of Disclosure and Placement Agents” policy in an effort to solicit an Investment from KRS? If yes, please continue to question 2; if no, please proceed to question 10.

No
2. Please disclose the name of the placement agency used, the names of the individuals contracted by the placement agency (either as employees or as sub-agents) in order to solicit an investment from KRS, and the fees paid or payable to the placement agent in connection with a prospective KRS investment.
3. Please represent that any fees paid to placement agents are the sole obligation of the investment manager and not that of KRS or the limited partnership.
4. Please disclose the names of any current or former Kentucky elected or appointed government officials (federal, state, and local government), KRS Board of Trustees members, employees, or consultants of KRS, or any other person, if any, who suggested the retention of the placement agent.
5. Please provide evidence of the regulatory agencies, if any, in any Federal, state or foreign jurisdiction the placement agent or any of its affiliates are registered with, such as the Securities and Exchange Commission (“SEC”), FINRA, or any similar regulatory agency.
6. Please provide a resume for each officer, partner or principal of the Placement Agent detailing the person’s education, professional designations, regulatory licenses and investment and work experience.
7. Please describe the services to be performed by the Placement Agent.
8. Please disclose whether the Placement Agent, or any of its affiliates, is registered as a lobbyist with any and all Kentucky state and local (county) governments.
9. Please disclose any political contributions made by the Placement Agent, a Placement Agent principal, or their family as defined by KRS 11A.010(4) to: any Kentucky official; political party; political organization; or other political entity within the prior 2 years.

10. Please disclose the names of any current or former Kentucky elected or appointed government officials (federal, state, and local government) KRS Board of Trustees members, employees, or consultants of KRS that are receiving any fees or compensation from the External Manager and/or placement agent. Please disclose any additional known relationships or conflicts with same.

Not applicable

11. Please disclose any political contributions made by External Manager, its principals, or their family as defined by KRS 11A.010(4) to any Kentucky official; political party; political organization; or other political entity in the prior 2 years.


Not applicable

12. Please disclose whether any principals of the firm are the subject of any pending litigation or have been involved in any regulatory proceedings related to the performance of their duties as an investment adviser. If so, please supply details concerning the issue.

Not applicable

13. Please provide a statement representing and warranting the accuracy of the information provided to KRS regarding the Statement of Disclosure, and acknowledge that similar language will be included in any final written agreement with a continuing obligation to update any such information within 10 business days of any change in the information.

Our firm represents and warrants the accuracy of the information provided to KRS regarding this Statement of Disclosure, and acknowledges that similar language will be included in any final written agreement with a continuing obligation to update any such information within 10 business days of any change in the information.

 15 Jan 2016
Signature Date

Print Name: CHRIS MARSHALL

Firm Name: PATRON CAPITAL GP V LIMITED

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board of Trustees

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: KRS Administrative Budget-to-Actual Expenditure Update

Accompanying this memorandum, you will find the spreadsheets showing KRS Administrative budget-to-actual expenditures for the second quarter (Q2) of Fiscal Year 2015-16. Key informational items for this period include:

- Total expenditures through December 31, totaled \$15.96 million with 61% of budget remaining.
- Overall, all expenditures including salaries and benefits remained below or on target with the budget.
- For the upcoming quarter, we expect higher technology expenditures than Q2 related to disaster recovery implementation, required server upgrades for .net versions, and contractor expenses for legal litigation and House Bill 62 agency withdrawal.
- Additional information includes two ancillary reports showing the split out of Internal Audit and Investments actual expenses (both within budgeted targets).

RECOMMENDATION: None. This item is presented for information purposes only.

KRS ADMINISTRATIVE BUDGET 2015-2016
SECOND QUARTER BUDGET-TO-ACTUAL ANALYSIS
For the Month Ended December 2015

Acc't #	Account Name	Budgeted	Actual	Remaining	% Remaining
	PERSONNEL				
111	Salaries	\$14,600,000	\$8,006,002	\$6,593,998	45.16%
120	Benefits	\$9,000,000	\$4,914,570	\$4,085,430	45.39%
131	Workers Compensation	\$34,000	\$32,365	\$1,635	4.81%
132	Unemployment	\$10,000	\$288	\$9,712	97.12%
133	Tuition Assistance	\$35,000	\$14,196	\$20,804	59.44%
133I	Investment Tuition Assistance	\$5,000	\$0	\$5,000	100.00%
133T	Audit Tuition Assistance	\$2,500	\$0	\$2,500	100.00%
135	Bonds	\$3,000	\$0	\$3,000	100.00%
141	LEGAL & AUDITING SERVICES				
141A	Legal Hearing Officers	\$344,000	\$95,364	\$248,636	72.28%
141B	Legal (Stoll, Keenon)	\$225,000	\$32,355	\$192,645	85.62%
141C	Polsinelli Shugart	\$100,000	\$0	\$100,000	100.00%
141E	Reinhart	\$350,000	\$42,152	\$307,848	87.96%
141F	Ice Miller	\$1,200,000	\$25,048	\$1,174,952	97.91%
142	Auditing	\$100,000	\$53,859	\$46,141	46.14%
146	CONSULTING SERVICES				
146A	Medical Reviewers	\$380,000	\$151,280	\$228,720	60.19%
146B	Medical Reports	\$10,000	\$0	\$10,000	100.00%
146C	Medical Exams	\$25,000	\$29,226	(\$4,226)	-16.90%
150	CONTRACTUAL SERVICES				
150C	Miscellaneous Contracts	\$270,000	\$69,418	\$200,582	74.29%
150D	Health Consultant	\$125,000	\$9,730	\$115,270	92.22%
150E	Banking	\$9,000	\$0	\$9,000	100.00%
150F	PBI	\$9,000	\$0	\$9,000	100.00%
150G	Human Resources Consulting	\$100,000	\$0	\$100,000	100.00%
150H	Health Insurance Admin Fee	\$2,200,000	\$856,042	\$1,343,958	61.09%
150I	Investment Consulting	\$600,000	\$144,103	\$455,897	75.98%
150J	Medical Claims TPA	\$2,941,997	\$0	\$2,941,997	100.00%
150K	Pharmacy Claims TPA	\$3,073,453	\$0	\$3,073,453	100.00%
159	Actuarial Services	\$600,000	\$254,324	\$345,676	57.61%
162	Facility Security Charges	\$3,000	\$689	\$2,311	77.03%
	PERSONNEL SUBTOTAL	\$36,354,950	\$14,731,011	\$21,623,939	59.48%

Acc't #	Account Name	Budgeted	Actual	Remaining	% Remaining
	OPERATIONAL				
211	Natural Gas	\$25,000	\$2,811	\$22,189	88.76%
212	Electric	\$190,000	\$84,805	\$105,195	55.37%
221	Rent-NonState Building	\$33,500	\$16,344	\$17,156	51.21%
222	Rent -State Owned Building	\$705,000	\$349,167	\$355,833	50.47%
223	Equipment Rental	\$5,000	\$897	\$4,103	82.06%
224	Copier Rental	\$86,000	\$27,490	\$58,510	68.04%
226	Rental Carpool	\$0	\$0	\$0	
232	Vehicle/Equip. Mainten.	\$29,000	\$1,482	\$27,518	94.89%
241	Postage	\$525,000	\$169,021	\$355,979	67.81%
242	Freight	\$1,200	\$313	\$887	73.90%
251	Printing (State)	\$1,000	\$0	\$1,000	100.00%
252	Printing (non-state)	\$300,000	\$53,604	\$246,396	82.13%
254	Insurance	\$85,000	\$2,650	\$82,350	96.88%
256	Garbage Collection	\$15,000	\$6,148	\$8,852	59.02%
259	Conference Expense	\$40,000	\$4,639	\$35,361	88.40%
259I	Conference Exp. Investment	\$12,600	\$2,408	\$10,192	80.89%
259T	Conference Exp. Audit	\$1,500	\$765	\$735	49.00%
300	MARS Usage	\$31,000	\$13,550	\$17,450	56.29%
321	Office Supplies	\$96,300	\$24,797	\$71,503	74.25%
331	Data Processing Supplies	\$45,000	\$3,000	\$42,000	93.33%
343	Motor Fuels & Lubricants	\$3,000	\$1,035	\$1,965	65.51%
346	Furniture & Office Equipment	\$50,000	\$0	\$50,000	100.00%
361	Travel (In-State)	\$109,000	\$52,297	\$56,703	52.02%
361I	Travel (In-State) Investment	\$1,500	\$409	\$1,091	72.73%
361T	Travel (In-State) Audit	\$500	\$136	\$364	72.79%
362	Travel (Out of State)	\$40,000	\$791	\$39,209	98.02%
362I	Travel (Out of State) Invest	\$51,050	\$8,818	\$42,232	82.73%
362T	Travel (Out of State) Audit	\$2,500	\$1,103	\$1,397	55.88%
381	Dues & Subscriptions	\$48,000	\$18,991	\$29,009	60.43%
381I	Dues & Subscriptions Invest	\$42,000	\$4,862	\$37,138	88.42%
381T	Dues & Subscriptions Audit	\$1,000	\$180	\$820	82.00%
399	Miscellaneous	\$20,000	\$7,131	\$12,869	64.34%
399I	Miscellaneous Investment	\$16,700	\$1,037	\$15,663	93.79%
399T	Miscellaneous Audit	\$500	\$238	\$262	52.49%
601	Capital Outlay	\$300,000	\$0	\$300,000	100.00%
802	COT Charges	\$90,000	\$43,400	\$46,600	51.78%
814	Telephone - Wireless	\$8,000	\$3,519	\$4,481	56.01%
815	Telephone - Other	\$150,000	\$39,040	\$110,960	73.97%
847	Computer Equip./Software	\$1,600,000	\$277,665	\$1,322,335	82.65%
847I	Comp. Equip./Software Invest	\$190,000	\$0	\$190,000	100.00%
847T	Comp. Equip./Software Audit	\$1,000	\$0	\$1,000	100.00%
	OPERATIONAL SUBTOTAL	\$4,951,850	\$1,224,545	\$3,727,305	75.27%
	TOTALS	\$41,306,800	\$15,955,556	\$25,351,244	61.37%

KRS ADMINISTRATIVE BUDGET 2015-16

INTERNAL AUDIT - BUDGET-TO-ACTUAL ANALYSIS

For the Month Ended December 2015

Acc't #	Account Name	Budgeted	Actual Expense	Remaining	% Remaining
	PERSONNEL (1)				
133T	Audit Tuition Assistance	\$2,500	\$0	\$2,500	100%
	PERSONNEL SUBTOTAL	\$2,500	\$0	\$2,500	100%
	OPERATIONAL				
259T	Conference Exp. Audit	\$1,500	\$765	\$735	49%
361T	Travel (In-State) Audit	\$500	\$136	\$364	73%
362T	Travel (Out of State) Audit	\$2,500	\$1,103	\$1,397	56%
381T	Dues & Subscriptions Audit	\$1,000	\$180	\$820	82%
399T	Miscellaneous Audit	\$500	\$238	\$262	52%
847T	Comp. Equip./Software Audit	\$1,000	\$0	\$1,000	100%
	OPERATIONAL SUBTOTAL	\$7,000	\$2,422	\$4,578	65%
	TOTALS	\$9,500	\$2,422	\$7,078	75%

INVESTMENT AUDIT - BUDGET-TO-ACTUAL ANALYSIS

For the Month Ended December 2015

Acc't #	Account Name	Budgeted	Actual Expense	Remaining	% Remaining
	PERSONNEL (1)				
133I	Investment Tuition Assistance	\$5,000	\$0	\$5,000	100%
	CONTRACTUAL SERVICES				
141E	Reinhart	\$350,000	\$42,152	\$307,848	88%
150I	Investment Consulting (2)	\$600,000	\$144,103	\$455,897	76%
	PERSONNEL SUBTOTAL	\$955,000	\$186,255	\$768,745	80%
	OPERATIONAL				
259I	Conference Exp. Investment	\$12,600	\$2,408	\$10,192	81%
361I	Travel (In-State) Investment	\$1,500	\$409	\$1,091	73%
362I	Travel (Out of State) Investment	\$51,050	\$8,818	\$42,232	83%
381I	Dues & Subscriptions Invest	\$42,000	\$4,862	\$37,138	88%
399I	Miscellaneous Investment	\$16,700	\$1,037	\$15,663	94%
847I	Comp. Equip./Software Investment	\$190,000	\$0	\$190,000	100%
	OPERATIONAL SUBTOTAL	\$313,850	\$17,534	\$296,316	94%
	TOTALS	\$1,268,850	\$203,790	\$1,065,060	84%

(1) Staff salaries are included in total KRS Budget reporting.

(2) Management Consulting Fees were expensed to the Trusts for Investment Fee Transparency.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Initial Retirement Cases, Second Quarter, 15-16

The tables below show the distribution of new retirees who retired during this quarter of the fiscal year by retirement mode and the retirees with 27 or more years of service.

DISTRIBUTION BY RETIREMENT MODE

<u>MODE</u>	<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>	<u>PERCENT</u>
Normal Retirement	116	245	0	361	29.0%
Early Retirement	262	465	6	733	58.0%
Disability Retirement	19	53	0	72	6.0%
Retirement Eligible Refund	23	23	0	46	4.0%
Death of Members Eligible to Retire	9	31	2	42	3.0%
Grand Totals	429	817	8	1254	100%

RETIREES WITH 27 OR MORE YEARS OF SERVICE

	<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
Under Normal Retirement Age	104	89	3	196
At and Over Normal Retirement Age	8	6	0	14
Grand Totals	112	95	3	210

RECOMMENDATION: This report is provided for informational purposes only. No action is required by the Board.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Death Benefit Payments, Second Quarter, 15-16

The table below reflects the number of deceased retired members whose death benefit was paid during this quarter of the fiscal year and the total amount paid by each system.

DEATH BENEFIT PAYMENTS

	<u>Number of Deceased Retirees</u>	<u>Total Amount Paid</u>
KERS	187	\$935,000.00
CERS	212	\$1,060,000.00
SPRS	5	\$25,000.00
TOTALS	<hr/> 404	<hr/> \$2,020,000.00

RECOMMENDATION: This report is provided for informational purposes only. No action is required by the Board.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Refund of Member Contributions for Quarter Ended December 2015

The summary by system, age, and service credit of each person who received a refund during the second quarter of this fiscal year is attached.

There were 1,219 refunds totaling \$7,546,369 paid to former members of the systems during the second quarter. Refund payments during the past (12) twelve quarters were as follows:

Quarter Ended	Amount	Number of Refunds
12/31/2015	\$7,546,369	1,219
09/30/2015	\$9,457,518	1,967
06/30/2015	\$7,830,169	1,334
03/31/2015	\$8,735,671	1,393
12/31/2014	\$7,953,236	1,338
09/30/2014	\$11,208,677	2,465
06/30/2014	\$8,829,317	2,167
03/31/2014	\$8,595,267	1,605
12/31/2013	\$8,063,089	1,696
09/30/2013	\$9,525,226	1,791
06/30/2013	\$7,892,029	1,986
03/31/2013	\$8,854,181	1,592

RECOMMENDATION: This report is provided for informational purposes only. No action is required from the Board.

Kentucky Retirement Systems

Refund Distribution by Age and Service

Start Date: 10/1/2015 End Date: 12/31/2015

Age	Years of Services					CERSHZ
	0 < 5	5 < 10	10 < 15	15 < 20	20 - Up	Totals
0 - 19	1	0	0	0	0	1
						2.00%
						935.57
						0.15%
20 - 29	8	7	2	0	0	17
						34.00%
						109420.26
						18.02%
30 - 39	4	7	2	0	7	20
						40.00%
						299832.75
						49.38%
40 - 49	2	0	4	0	3	9
						18.00%
						178921.8
						29.47%
50 - 59	1	0	0	0	1	2
						4.00%
						9733.56
						1.60%
60 - Up	1	0	0	0	0	1
						2.00%
						8368.2
						1.38%
CERSHZ						
Totals	17	14	8	0	11	50
	34.00%	28.00%	16.00%	0.00%	22.00%	100.00%
	50201.8	120681.6	142156.85	0	294171.89	607212.14
	8.27%	19.87%	23.41%	0.00%	48.45%	100.00%

Kentucky Retirement Systems

Refund Distribution by Age and Service

Start Date: 10/1/2015 End Date: 12/31/2015

Age	Years of Services					CERSNHZ
	0 < 5	5 < 10	10 < 15	15 < 20	20 - Up	Totals
0 - 19	1	0	0	0	0	1
						0.17%
						24.63
						0.00%
20 - 29	53	31	9	0	1	94
						15.54%
						290260.81
						9.44%
30 - 39	50	42	16	9	14	131
						21.65%
						752288.92
						24.46%
40 - 49	58	41	21	14	29	163
						26.94%
						1081751.52
						35.18%
50 - 59	42	28	22	5	16	113
						18.68%
						696998.83
						22.66%
60 - Up	63	30	10	0	0	103
						17.02%
						253907.38
						8.26%
CERSNHZ						
Totals	267	172	78	28	60	605
	44.13%	28.43%	12.89%	4.63%	9.92%	100.00%
	348604.44	722984.41	558816.84	298013.07	1146813.33	3075232.09
	11.34%	23.51%	18.17%	9.69%	37.29%	100.00%

Kentucky Retirement Systems

Refund Distribution by Age and Service

Start Date: 10/1/2015 End Date: 12/31/2015

Age	Years of Services					KERSHZ
	0 < 5	5 < 10	10 < 15	15 < 20	20 - Up	Totals
0 - 19	0	0	0	0	0	0
						0.00%
						0
						0.00%
20 - 29	16	7	3	0	0	26
						26.00%
						109713.04
						14.99%
30 - 39	18	14	3	3	6	44
						44.00%
						360375.53
						49.25%
40 - 49	8	5	2	2	3	20
						20.00%
						223323.19
						30.52%
50 - 59	3	0	2	0	0	5
						5.00%
						32589.22
						4.45%
60 - Up	5	0	0	0	0	5
						5.00%
						5751.6
						0.79%
KERSHZ						
Totals	50	26	10	5	9	100
	50.00%	26.00%	10.00%	5.00%	9.00%	100.00%
	106841.46	164655.83	125689.51	98992.4	235573.38	731752.58
	14.60%	22.50%	17.18%	13.53%	32.19%	100.00%

Kentucky Retirement Systems

Refund Distribution by Age and Service

Start Date: 10/1/2015 End Date: 12/31/2015

Age	Years of Services					KERSNHZ
	0 < 5	5 < 10	10 < 15	15 < 20	20 - Up	Totals
0 - 19	5	0	0	0	0	5
						1.08%
						3430.37
						0.11%
20 - 29	50	19	7	2	0	78
						16.88%
						252708.74
						8.08%
30 - 39	50	52	19	15	12	148
						32.03%
						1017802.27
						32.55%
40 - 49	40	24	21	12	20	117
						25.32%
						1202654.43
						38.46%
50 - 59	30	21	11	5	4	71
						15.37%
						522882.5
						16.72%
60 - Up	28	9	6	0	0	43
						9.31%
						127769.68
						4.09%
KERSNHZ						
Totals	203	125	64	34	36	462
	43.94%	27.06%	13.85%	7.36%	7.79%	100.00%
	303174.07	712144.72	654524.23	567819.96	889585.01	3127247.99
	9.69%	22.77%	20.93%	18.16%	28.45%	100.00%

Kentucky Retirement Systems

Refund Distribution by Age and Service

Start Date: 10/1/2015 End Date: 12/31/2015

Age	Years of Services					SPRSZH
	0 < 5	5 < 10	10 < 15	15 < 20	20 - Up	Totals
0 - 19	0	0	0	0	0	0
						0.00%
						0
						0.00%
20 - 29	1	0	0	0	0	1
						50.00%
						4830.1
						98.10%
30 - 39	1	0	0	0	0	1
						50.00%
						93.71
						1.90%
40 - 49	0	0	0	0	0	0
						0.00%
						0
						0.00%
50 - 59	0	0	0	0	0	0
						0.00%
						0
						0.00%
60 - Up	0	0	0	0	0	0
						0.00%
						0
						0.00%
SPRSZH						
Totals	2	0	0	0	0	2
	100.00%	0.00%	0.00%	0.00%	0.00%	100.00%
	4923.81	0	0	0	0	4923.81
	100.00%	0.00%	0.00%	0.00%	0.00%	100.00%

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board
FROM: William A. Thielen, Executive Director
DATE: February 18, 2016
SUBJECT: Report of Decisions by the Medical Examiners

DISABILITY

During the second quarter of the fiscal year, the Medical Examiners reviewed a total of 166 applicants for disability retirement. There were 75 (45.18%) recommended for approval and 91 (54.82%) recommended for denial.

Approvals

<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
20	55	0	75

Duty Related Approvals

<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
0	0	0	0

Denials

<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
25	66	0	91

HAZARDOUS DISABILITY

During the second quarter of the fiscal year, the Medical Examiners reviewed a total of 11 applicants for hazardous disability retirement. There were 5 (45.45%) recommended for denial and 6 (54.55%) recommended for approval.

Approvals

<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
0	5	0	5

In the Line of Duty Approvals

<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
0	1	0	1

Total and Permanent Approvals

<u>KERS</u>	<u>CERS</u>	<u>SPRS</u>	<u>TOTAL</u>
0	0	0	0

ANNUAL REVIEW OF DISABILITY RECIPIENTS

During the second quarter of the fiscal year, the Medical Examiners made final decisions on a total of 175 annual reviews of disability recipients. The disability benefits of 166 recipients (94.86%) were continued and the disability benefits of 9 recipients (5.14%) were terminated.

RECOMMENDATION: This is for informational purposes only. No action is required by the board.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Disability Appeals Committee Quarterly Report

The Disability Appeals Committee held meetings on October 29, November 30 and December 21, 2015. A total of 31 disability claims were acted upon during the quarter resulting in 21 denials, 6 approvals, 3 dismissals and 1 remand.

Denials

KERS	CERS	SPRS
4	17	0

Approvals

KERS	CERS	SPRS
2	4	0

Dismissals

KERS	CERS	SPRS
3	0	0

Remands

KERS	CERS	SPRS
0	1	0

RECOMMENDATION: This is for informational purposes only. No action is required by the Board.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Administrative Appeals Committee Quarterly Report

The Administrative Appeals Committee held meetings on October 29, November 30 and December 21, 2015. A total of 11 cases were acted upon in the quarter resulting in 1 remand, 2 not bona fide and 8 dismissals.

<u>Denials</u>		
KERS	CERS	SPRS
0	0	0
<u>Continuances</u>		
KERS	CERS	SPRS
0	0	0
<u>Discontinuances</u>		
KERS	CERS	SPRS
0	0	0
<u>Reinstatements</u>		
KERS	CERS	SPRS
0	0	0
<u>Not Bona Fide</u>		
KERS	CERS	SPRS
0	2	0
<u>Remands</u>		
KERS	CERS	SPRS
1	0	0
<u>Dismissals</u>		
KERS	CERS	SPRS
2	6	0

RECOMMENDATION: This is for informational purposes only. No action is required by the Board.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board
FROM: William A. Thielen
DATE: February 18, 2016
SUBJECT: Participation of Additional Agencies and Hazardous Positions

PARTICIPATION—NONHAZARDOUS

There is one (1) new agency electing to participate with the County Employees Retirement System under non-hazardous coverage. Copies of minutes, resolutions to participate and agency budgets will be available at the meeting for review. Contract for Health Insurance has been received for the agency electing to participate in CERS.

RECOMMENDATION: The Executive Director recommends that the Board approve the participation of City of Jeffersonville.

THE FOLLOWING AGENCIES ARE ASKING FOR HAZARDOUS DUTY COVERAGE ON POSITIONS FOR EMPLOYEES WHO HAVE A PARTICIPATION DATE PRIOR TO SEPTEMBER 1, 2008.

Louisville Jefferson County Metro Government has requested hazardous duty coverage for the following positions with an effective date of March 1, 2016:

**Licenses & Permits Investigator
Licenses & Permits Manager**

Licenses & Permits Supervisor

There are no new employees to be covered under hazardous duty coverage at this time. Attached are copies of the Position Questionnaires and Job Descriptions.

HAZARDOUS POSITIONS (FOR EMPLOYEES HIRED 9/1/08 OR AFTER)

Louisville Jefferson County Metro Government has requested hazardous duty coverage for the following positions with an effective date of March 1, 2016:

**Licenses & Permits Investigator
Licenses & Permits Manager**

Licenses & Permits Supervisor

There are no new employees to be covered under hazardous duty coverage at this time. Attached are copies of the Position Questionnaires and Job Descriptions.

RECOMMENDATION: The positions for which hazardous duty has been requested are presented for discussion.

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Applications to Voluntary Cease Participation in KERS

1. Commonwealth Credit Union
2. Kentucky Mutual Employees Insurance
3. Council of State Governments

Three participating employers, Commonwealth Credit Union, Kentucky Mutual Employees Insurance, and Council of State Governments, timely filed Forms 7730, Application to Voluntarily Cease Participation in CERS or KERS pursuant to Kentucky Revised Statute 61.522. All three employers filed the necessary documents, tendered the \$10,000 deposit, paid all outstanding invoices, and corrected all errors in reporting within their control.¹ None of these employers was a party to pending litigation with KRS. All three employers have expressed their intent to pay the full actuarial cost of withdrawal by lump sum payment.² Except for confidential employee data a copy of the applications and all supporting documentation have been provided in your materials.

As required by 105 KAR 1:145E Section 6(1), KRS sent initial notices to the affected employees on or about February 18, 2016. A copy of the initial notice is attached.

Commonwealth Credit Union, Kentucky Mutual Employees Insurance, and Council of State Governments have satisfied all the requirements to file an application to voluntarily cease participating established in 105 KAR 1:145E. Pursuant to 105 KAR 1:145E Section 4(6), the Board of Trustees must vote to either accept or reject these applications for processing.

RECOMMENDATION: Staff recommends that the Board of Trustees accept for processing the Form 7730, Applications for Voluntary Cessation from KERS filed by Commonwealth Credit Union, Kentucky Mutual Employees Insurance, and Council of State Governments.

¹ Commonwealth Credit Union had one outstanding error that required additional issue analysis by KRS' Legal Dept. regarding creditable compensation. That analysis had not been completed prior to December 31, 2015.

² The requirements for filing are attached to this memorandum.

SUMMARY OF KERS/CERS **VOLUNTARY CESSATION PROCESS**

- I.** Resolution of Employer: The governing body of the employer must pass a resolution to voluntarily cease participation that includes the following provisions:
- (a) the employer has decided to voluntarily cease participation;
 - (b) the employer acknowledges that it is subject to KRS 61.522 and this administrative regulation;
 - (c) the employer acknowledges that it shall pay the full actuarial cost of withdrawal and all administrative costs;
 - (d) the employer acknowledges that its employees will no longer earn service credit for employment with the employer after the employer's approved cessation date;
 - (e) the employer agrees to cooperate with Kentucky Retirement Systems to educate its employees about the effect of the employer's cessation on their retirement accounts and their options regarding their retirement accounts; and
 - (f) that the employer shall not mandate, force, or require, its employees to take a refund of their accumulated account balance or retaliate against its employees who do not chose to take refunds of their accumulated account balance.
- II.** Outstanding Issues: KRS will not accept the application of an employer who:
- 1) has not paid or resolved its outstanding invoices;
 - 2) has errors in reporting; or
 - 3) is party to a pending legal action in which KRS is an adverse party.
- III.** Required Documents: The employer must attach the following documents to its application:
- 1) the employer's resolution
 - 2) A notarized copy of the official minutes of the meeting in which the Resolution was adopted;
 - 3) The employer's Articles of Incorporation, if applicable;
 - 4) The employer's current By-Laws, if applicable;

- 5) The employer's Certificate of Existence/Authorization from the Kentucky Secretary of State, if applicable;
- 6) Documentation of the alternative retirement program created by or being created by the employer for its employees, including a detailed written description of the alternative retirement program;
- 7) For each current and former full time employee:
 - i. Full names;
 - ii. Last known addresses;
 - iii. Dates of birth;
 - iv. Social security numbers or Kentucky Retirement Systems member ids;
 - v. Beginning dates of employment;
 - vi. Ending dates of employment, if applicable; and
 - vii. Sick leave balances.
- 8) The employer's most recent audited financial statement and independent auditor's report.
- 9) The employer's most recent five (5) Consolidated Annual Financial Reports;
- 10) Documentation of the employer's plan to pay the full actuarial cost including:
 - i. Funding source;
 - ii. List of real property owned by the employer, including deeds of conveyance, title, all liens or encumbrances on the real property and any current written contractual lease or rental agreement of the real property identified;
 - iii. List of liabilities of the employer;
 - iv. Inventory of all other chattel and personal property owned by the employer or in which the employer has an interest that may be used as collateral by the employer, including a description of the property, location of the property, and an estimated value;
- 11) Proposed Detailed Financing Statement, if the employer intends to pay in installments; and
- 12) List of active lawsuits, legal actions, arbitrations, mediations and other litigation, except for cases in which the employer is seeking to collect a debt owed to it by one of its members, pending to which the employer is a party including:
 - i. Name of the case;
 - ii. Number of the case;
 - iii. The name and address of the Court, arbitrator, mediator, or administrative agency in which the case is pending; and
 - iv. A copy of the Complaint or a description of the allegations made in the Complaint as well as the type and amount of relief sought by the Plaintiff(s).

EXAMPLE INITIAL NOTICE

{Full_Name}
{ADDRESS_LINE_1}
{ADDRESS_LINE_2}
{CITY} {STATE} {ZIP_CODE}

Dear {Full_Name}:

This notice is to inform you that your current or former employer, {Agency Name1}, has filed an application with Kentucky Retirement Systems (KRS) to voluntarily cease participation in the {System1}. The Board of Trustees of KRS will decide whether to accept {Agency Name2}'s application for processing at its regularly scheduled quarterly meeting in February 2016. If the application for processing is accepted by KRS' Board of Trustees, {Agency Name2} will cease participating in {System2} after June 30, 2016. A final determination regarding {Agency Name2}'s application to cease participation in {System2} is not expected until the spring of 2017.

If {Agency Name2}'s voluntary cessation application is accepted for processing, your {System2} account may be affected in certain ways. Some of the possible effects are listed in items 1-5 below.

1. If you are retired in {System2} on or before June 30, 2016, you are not affected by {Agency Name2}'s voluntary cessation of participation in {System2} unless a discrepancy is identified in your account.
2. If you are not retired in {System2} on or before June 30, 2016, then the benefit that you have earned under {System2} through June 30, 2016 is not affected by {Agency Name2}'s voluntary cessation of participation in {System2}, so long as you do not choose to take a refund of your employee contribution account balance.
3. Effective July 1, 2016, you will no longer earn additional service credit in {System2} through {Agency Name2}.
4. Effective July 1, 2016, you will no longer make employee contributions to {System2} through {Agency Name2}.
5. Your ability to purchase service may be affected. More information regarding service purchases is attached.

If you identify a discrepancy in your account information, have questions, or desire to purchase service credit, please send your name and contact information to KRSEmployerWithdrawal@kyret.ky.gov. You are encouraged to utilize Kentucky Retirement Systems' Member Self-Service to review your account information at <https://myretirement.ky.gov>. Additional information regarding accessing Member Self-Service is attached. In addition to the tools available through KRS' Member Self-Service interface, KRS' webpage <https://kyret.ky.gov> contains a wealth of information intended to assist members in understanding KRS. Specifically, there are several publications on KRS' website that provide general information about KRS and its benefits available at <https://kyret.ky.gov/about/Publications/Pages/default.aspx>.

**Commonwealth Credit Union
Board of Directors
Meeting Minutes
December 17, 2015**

The Board of Directors of Commonwealth Credit Union met on Thursday, December 17, 2015.

Roll Call

The following Directors were present: Alex Rose, Chairman; Kenny Blackwell; Robin Brewer; Jim Chadwell, Secretary/Treasurer; Randy Fawns; Mary Foster; Regina Grubbs, Vice Chairperson; Karen Harbin, President; Kay Jones; Bill Leach; Randy Overstreet; and Harry Suter. Also present were: Gary Forman, Supervisory Committee Chairperson; David Young, Executive Vice President; Steve Bellas, Chief Financial Officer; Alan Davis, Vice President of Lending; Karen Maxfield, Vice President of Human Resources; Gloria Thomas, Vice President of Branch Services; and Allison Harp, Executive Staff Advisor.

Alex Rose called the meeting to order at 4:04PM, with a quorum in attendance. Mr. Rose gave the invocation.

Consent Agenda

*Jim Chadwell, Secretary/Treasurer, presented the Consent Agenda. The Consent Agenda included the November 19, 2015 Board Minutes; New and Closed Membership Accounts; Official Family loans; Loan Charge-off accounts; Negative Account Charge-offs; Plastic Card Charge-offs; and the New Loan Tracking Report. **Mr. Chadwell made a motion to approve the consent agenda as presented with a second by Kay Jones. The motion carried with Randy Overstreet abstaining from the vote.***

**Supervisory
Committee Report**

*Gary Forman, Supervisory Committee Chairperson, presented the report. Internal Audit continued audit fieldwork on the Consumer Lending, Fair Lending and Employee payroll and Corporate Credit Card audits. Policy Works Inc., external consulting firm, completed and issued final audit reports on the Bank Secrecy Act/OFAC, SAFE Act and Automated Clearing House audits. The question was asked about Policy Works Inc. contracting to do the audits and if the Supervisory Committee was pleased with their work. Mr. Forman stated they were not completely satisfied with their work because they did not come on-site to do the fieldwork, all of the information was sent to them remotely. He stated the Committee will look at this for future audits. **Harry Suter made a motion to accept the report with a second by Jim Chadwell. The motion carried.***

**Asset Liability
Management
Committee Report**

Kenny Blackwell, Committee Chairperson, presented the report. Mr. Blackwell stated the normal monthly reports were reviewed with no exceptions noted. The Committee also reviewed the Rate Shock reports and the Suspicious Activity Report Summary.

The Committee reviewed the investments sold, purchased as well as the market value of the investment portfolio rate shocked 300+/- basis points.

*Item #3 of the report was the Committee's review of the proposed dividend rates for January 2016. **Mr. Blackwell made a motion to approve the January 2016 Dividend Rates, as presented with a second by Randy Overstreet. The motion carried.***

*Item #4 of the report was the Committee's review of management's recommendation to approve the Indirect Vehicle Loan Term Increase Program. The maximum loan term increase is 12 months and the maximum loan term will remain at 84 months. The program will begin on January 1, 2016. **Mr. Blackwell made a motion to approve the***

Indirect Vehicle Loan Term Increase Program, as presented. Randy Fawns seconded the motion and the motion carried.

Item #5 of the report was the Committee's review of management's recommendation to approve an Indirect Vehicle Loan Interest Rate Match Program. The program will begin on January 1, 2016. This would match rates up to 100 basis points. The program will be offered for six months and will be reviewed by the Committee in July 2016. Mr. Blackwell made a motion to approve the Indirect Vehicle Loan Interest Rate Match Program, as presented with a second by Kay Jones. The motion carried.

Item #6 of the report was the Committee's review of management's recommendation for the credit union to pay new Indirect Member's \$5.00 membership deposit to improve efficiencies. The Indirect Loan New Member Deposit Program will begin January 1, 2016. Mr. Blackwell made a motion to approve the Indirect Loan New Member Deposit Program, as presented. Randy Fawns seconded the motion and it carried.

Item #7 of the report was the Committee's review of the 2016 Operating Budget. Mr. Blackwell made a motion to approve the 2016 Operating Budget, as presented with a second by Randy Overstreet. The motion carried.

**Loan Review
Committee Report**

Robin Brewer, Committee Chairperson, presented the report. Ms. Brewer noted that all normal monthly items were reviewed with no exceptions noted.

Item #5 of the report was the Committee's review of the Sunset Hill Development CBS loan participation for \$350,000. Ms. Brewer made a motion to approve the Sunset Hill Development CBS loan participation, as presented with a second by Randy Fawns. The motion carried.

Item #6 of the report was the Committee's review of the Union Village/Parkside Shopping Center Extensia Financial loan participation for \$500,000. Ms. Brewer made a motion to approve the Union Village/Parkside loan participation, as presented. Harry Suter seconded the motion and it carried.

Item #7 of the report was for informational purposes only. The Committee reviewed the Business Partners Risk Rate Ratio Analysis.

**Technology
Committee Report**

Mary Foster, Committee Chairperson, presented the Technology Committee Report.

Item #2 of the report was the Committee's review of the revisions to the Security Program and Safeguarding Member, Borrower, and Customer Personal Information. Ms. Foster made a motion to approve the Security Program, as presented with a second by Regina Grubbs. The motion carried.

**Executive Committee
Report**

Regina Grubbs, Committee Chairperson, presented the report. Mrs. Grubbs noted that all normal monthly items were reviewed with no exceptions noted.

Item #3 of the report was the Committee's review of the 2015 DFI/NCUA Examination and management's response. Mrs. Grubbs made a motion to approve management's response to the 2015 DFI/NCUA Examination, as presented. Kay Jones seconded the motion and it carried.

Item #4 of the report was the Committee's review of the \$500 add-on over the limit Holiday Loan promotion for official family accounts. Mrs. Grubbs made a motion to

approve the list of official family accounts utilizing the \$500 add-on over the limit Holiday Loan Promotion with a second by Robin Brewer. The motion carried.

Item #5 of the report was the Committee's review of the 2016 Holiday Schedule. The credit union will start following the Federal Reserve Bank holiday schedule. This will simplify holidays in the future. Mrs. Grubbs made a motion to approve the 2016 Holiday Schedule, as presented. Jim Chadwell seconded the motion. Discussion followed about whether this needed to be approved every year and it was suggested it be brought to the Board as an informational item. The motion carried.

Mrs. Grubbs stated the remaining Executive Committee items would be discussed in Executive Session.

**Marketing/Business
Development/
Facilities/Support
Services Report**

David Young, Executive Vice President, presented the Marketing, Business Development, Facilities, and Support Services Report.

Mr. Young reported on the Shelbyville Branch. The first coat of paint has been applied to the interior and have begun bricking the outside. Our ribbon cutting ceremony is April 12th. We will have festivities the entire week of April 11-15th. The soft opening is scheduled for March 1st.

**Branch Services
Report**

Gloria Thomas, Vice President of Branch Services presented the Branch Services Report.

Finance Area Report

Steve Bellas, Chief Financial Officer, presented the Finance Area Report.

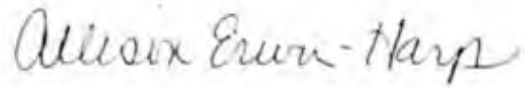
Mr. Bellas reported the Fed raised interest rates to 0.25%. We are in the process of evaluating our loans to coincide when the prime rate changes, specifically our variable rate loans.

Mr. Bellas stated the credit union took a large provision expense in November. We are studying those numbers after re-scoring all of our loan accounts. We saw a large movement from the A grade to E grade. We are re-programming so we can mitigate some of these swings we see with the re-scoring.

Alan Davis stated we have been pulling credit re-scores since 2013. Each time we do this, we have a large movement. We have made numerous attempts to mitigate the movement and all those fixes have made minor adjustments to the numbers. This time we are looking at joint loans and the joint borrowers and comparing that score to the original score. We had 51 accounts out of our \$723M portfolio. It has become a reality for members' scores to change; they change all the time. Most of our loans, when we make them are A++ grade. It is a shock when we see the adjustments that have to be made but this is the sixth time we have done the pull. There are still large movements we have to deal with and it's unfortunate because it is an expense because we have to reserve more money for the allowance account. It seems to be normal for our portfolio. The good news is delinquency is still low and our charge off ratios are slightly higher than peer because we have more unsecured loans than peer. Our yield is higher on unsecured but we take the risk to have more losses. This is an ongoing issue we will continue to evaluate. Lending is risky but we are working to mitigate the risk. We do the credit score pulls twice a year, we are required to do them annually. We pull a soft hit on all accounts that have a loan twice a year. For a four year period, we did not pull scores so we weren't tracking it. The allowance account is very volatile. We continue to review the loans we make and our methodology.

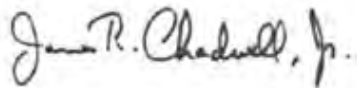
- Lending Area Report** *Alan Davis, Vice President of Lending, presented the Lending Area Report.*
- Human Resources/Education Report** *Karen Maxfield, Vice President of Human Resources presented the Human Resources and Education Area Report.*
- Mrs. Maxfield expressed staffs appreciation and thanks to the Board for the Christmas Bonus.*
- President's Report** *Karen Harbin, President, presented the President's Report.*
- Mrs. Harbin presented the quarterly update to the 2015 Strategic Plan. Regina Grubbs made a motion to approve the updates to the 2015 Strategic Plan, as presented with a second by Harry Suter. The motion carried.*
- Chairman of the Board's Report** *Alex Rose, Chairman, presented the Chairman of the Board's report. Included in the report were volunteer education opportunities and member commendations.*
- Randy Overstreet made a motion to go into Executive Session with a second by Regina Grubbs. The motion carried.*
- Harry Suter made a motion to adjourn from Executive Session with a second by Regina Grubbs. The motion carried.*
- Mrs. Grubbs made a motion to approve the 2016 Salary Administration Program, as presented with a second by Kay Jones. The motion carried with Karen Harbin abstaining from the vote.*
- Regina Grubbs made a motion to go into Executive Session with a second by Jim Chadwell. The motion carried.*
- Harry Suter made a motion to adjourn from Executive Session with a second by Kay Jones. The motion carried.*
- Mrs. Grubbs made a motion to approve filing the applications and providing the necessary documentation to KERS for voluntary cessation effective June 30, 2016. Harry Suter seconded the motion and it carried with Karen Harbin and Randy Overstreet abstaining from the vote.*
- Mrs. Grubbs made a motion to adopt the Board Resolution of Commonwealth Credit Union as set forth to voluntarily cease participation in the Kentucky Employees Retirement System. Randy Fawns seconded the motion and it carried with Karen Harbin and Randy Overstreet abstaining from the vote.*
- With no further business to discuss, the Board meeting adjourned at 6:00PM.*

Prepared by:



Allison Erwin-Harp, Executive Staff Advisor

Respectfully Submitted by:



Jim Chadwell, Secretary/Treasurer

Approved by:



Alex Rose, Chairman of the Board

The December 17, 2015 Board Minutes were approved by all Board members on December 18, 2015, via phone call and email.

State of Kentucky
County of Franklin

Jessica A. Bird
Kentucky Notary Public State at Large

12/10/16
Commission Expires





**PUBLIC PROTECTION CABINET
DEPARTMENT OF FINANCIAL INSTITUTIONS**

Matthew G. Bevin
Governor

1025 Capital Center Drive, Suite 200
Frankfort, KY 40601
Phone: (502) 573-3390
Fax: (502) 573-8787
<http://kfi.ky.gov>

David A. Dickerson
Secretary

Charles A. Vice
Commissioner

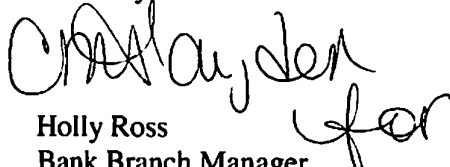
December 29, 2015

Ms. Karen Harbin
Commonwealth Credit Union
417 High Street
Frankfort, Kentucky 40601

Dear Ms. Harbin:

This is to certify that Commonwealth Credit Union, headquartered at 417 High Street, Frankfort, Kentucky, is supervised by the Kentucky Department of Financial Institutions and was chartered as a state credit union on April 2, 1951. Based on existing agency records, and as of the date of this letter, Commonwealth Credit Union, Frankfort, Kentucky, continues to be duly chartered and in good standing with this agency.

Sincerely,


Holly Ross
Bank Branch Manager
Depository Division

**BOARD RESOLUTIONS
COMMONWEALTH CREDIT UNION**

RESOLVED: That Commonwealth Credit Union ("CCU") elects to voluntarily cease participation in the Kentucky Employees Retirement System ("KERS") effective as of June 30, 2016, in accordance with relevant law; and

FURTHER RESOLVED: That CCU shall file with the Kentucky Retirement Systems a Form 7725, Request for Estimated Actuarial Cost of Voluntary Cessation, and a Form 7730, Application for Voluntary Cessation from CERS or KERS, in accordance with rules promulgated under 105 KAR 1:145E; and

FURTHER RESOLVED: That CCU acknowledges that:

(1) CCU is subject to the requirements and restrictions associated with such voluntary cessation as set forth in KRS 61.522 and 105 KAR 1:145E; and

(2) CCU must pay the full actuarial cost of withdrawal and all associated administrative costs in order to voluntarily cease participation in KERS; and

(3) CCU employees will earn no service credit under KERS with regard to employment with CCU that occurs after June 30, 2016; and

FURTHER RESOLVED: That CCU will cooperate with the Kentucky Retirement Systems to:

(1) educate CCU employees about the effect that CCU's cessation of participation in KERS will have on their retirement accounts; and

(2) inform CCU employees about available options regarding their retirement accounts; and

FURTHER RESOLVED: That CCU shall not mandate, force, or require its employees to take refunds of their accumulated account balances as defined by KRS 61.510(41) or 78.510(38), or retaliate against its employees who choose not to take refunds of their accumulated account balances as defined in KRS 61.510(41) or 78.510(38); and

FURTHER RESOLVED: That both the President/CEO of CCU and the CCU Board Chair are hereby authorized to execute any documents and take whatever action is necessary in order to implement the foregoing resolutions.

The undersigned, being the duly elected, qualified and acting Chairman of the Board of Directors of Commonwealth Credit Union, hereby certifies that the Resolutions appearing above were adopted by the Board of Directors of Commonwealth Credit Union, acting with full power and lawful authority, at a meeting of said Board that occurred on December 17, 2015. I also hereby certify that the Minutes of said December 17, 2015 Board meeting, which included said Resolutions, were subsequently approved at a separate meeting of the Board of Directors of Directors of Commonwealth Credit Union that occurred on December 18, 2015.

Dated: 12-18-15

Alex W. Rose
Alex W. Rose, Chairman

State of Kentucky
County of Franklin

The foregoing instrument was acknowledged, subscribed, and sworn before me this December 18, 2015 by Alex W. Rose, Chairman of the Board of Directors of Commonwealth Credit Union, a Kentucky corporation, on behalf of the corporation.

Jessica A. Bird
I, Jessica Bird, a
Kentucky Notary Public State at Large; my
commission expires: 12/10/16



Orth, Chakler, Murnane and Company, CPAs

A Professional Association

12060 S. W. 129th Court, Suite 201, Miami, Florida 33186-4582 • Telephone 305-232-8272 • Fax 305-232-6388

Web site: www.ocmcpa.com

Douglas J. Orth, CPA, CFE, Managing Partner

Hugh S. Chakler, CPA, CISA, CITP, CFE

John J. Murnane, CPA

James A. Griner, CPA

Lori J. Carmichael, CPA

Daniel C. Moulton, CPA

INDEPENDENT AUDITORS' REPORT

March 7, 2011

To the Supervisory Committee of
Commonwealth Credit Union

We have audited the accompanying statement of financial condition of Commonwealth Credit Union as of December 31, 2010, and the related statements of income, comprehensive income, members' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Credit Union's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Commonwealth Credit Union as of December 31, 2009, were audited by other auditors whose report dated April 6, 2010, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Credit Union as of December 31, 2010, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Orth, Chakler, Murnane & Co.

Orth, Chakler, Murnane & Company
Certified Public Accountants

OCM&Co

A PROFESSIONAL ASSOCIATION

CPAS

COMMONWEALTH CREDIT UNION STATEMENTS OF FINANCIAL CONDITION
--

ASSETS

	As of December 31,	
	2010	2009
Cash and cash equivalents	\$20,637,102	\$11,720,225
Non-negotiable certificates of deposit	39,908,298	100,569,199
Investments:		
Available-for-sale	260,078,852	221,112,825
Held-to-maturity	1,207,321	2,781,521
Loans to members, net of allowance for loan losses	520,476,803	503,843,263
Accrued interest receivable	3,329,212	4,019,916
Property and equipment	21,001,407	21,661,156
NCUSIF deposit	7,377,552	7,411,482
Federal Home Loan Bank Stock	1,711,300	1,711,300
Membership capital shares at corporate credit unions	691,986	802,960
Other real estate owned	968,824	970,553
Prepaid and other assets	2,828,320	4,646,905
Total assets	\$880,216,977	\$881,251,305

LIABILITIES AND MEMBERS' EQUITY

	As of December 31,	
	2010	2009
LIABILITIES:		
Members' share and savings accounts	\$718,511,847	\$727,131,258
Accounts payable	3,525,078	3,834,690
Accrued liabilities	4,718,908	3,936,207
Total liabilities	726,755,833	734,902,155
Commitments and contingent liabilities	—	—
MEMBERS' EQUITY:		
Regular reserve	20,827,421	20,827,421
Undivided earnings	131,581,882	124,396,351
Accumulated other comprehensive income	1,051,841	1,125,378
Total members' equity	153,461,144	146,349,150
Total liabilities and members' equity	\$880,216,977	\$881,251,305

The accompanying notes are an integral part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF INCOME

	For the years ended December 31,	
	2010	2009
INTEREST INCOME:		
Loans to members	\$34,026,440	\$34,570,323
Investments	6,674,048	10,126,900
Total interest income	<u>40,700,488</u>	<u>44,697,223</u>
INTEREST EXPENSE:		
Members' share and savings accounts	10,064,084	16,264,122
Borrowed funds	3,625	3,849
Total interest expense	<u>10,067,709</u>	<u>16,267,971</u>
Net interest income	30,632,779	28,429,252
PROVISION FOR LOAN LOSSES	3,404,052	7,414,322
Net interest income after provision for loan losses	<u>27,228,727</u>	<u>21,014,930</u>
NON-INTEREST INCOME:		
Income from NCUSIF	—	4,225,924
Fees and service charges	10,680,072	9,904,908
Total non-interest income	<u>10,680,072</u>	<u>14,130,832</u>
	<u>37,908,799</u>	<u>35,145,762</u>
NON-INTEREST EXPENSE:		
Compensation and employee benefits	18,503,711	16,756,275
Office operating and occupancy	8,844,211	8,771,849
NCUA premium assessments	1,870,886	1,089,222
Miscellaneous operating	1,393,486	1,344,263
Impairment of membership capital shares at corporate credit unions	110,974	2,921,034
Total non-interest expense	<u>30,723,268</u>	<u>30,882,643</u>
Net income	<u>\$7,185,531</u>	<u>\$4,263,119</u>

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF COMPREHENSIVE INCOME

	For the years ended December 31,	
	2010	2009
NET INCOME	\$7,185,531	\$4,263,119
OTHER COMPREHENSIVE LOSS:		
Unrealized holding gains/(losses) arising during the year on investments classified as available-for-sale	(73,537)	(118,382)
Reclassification adjustments for (gains)/losses included in net income	—	—
Other comprehensive loss	(73,537)	(118,382)
Comprehensive income	\$7,111,994	\$4,144,737

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF MEMBERS' EQUITY
--

For the years ended December 31, 2010 and 2009				
	Regular Reserve	Undivided Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
Balance, December 31, 2008	\$20,827,421	\$120,133,232	\$1,243,760	\$142,204,413
Net income	—	4,263,119	—	4,263,119
Other comprehensive loss	—	—	(118,382)	(118,382)
Balance, December 31, 2009	20,827,421	124,396,351	1,125,378	146,349,150
Net income	—	7,185,531	—	7,185,531
Other comprehensive loss	—	—	(73,537)	(73,537)
Balance, December 31, 2010	\$20,827,421	\$131,581,882	\$1,051,841	\$153,461,144

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$7,185,531	\$4,263,119
Adjustments:		
Provision for loan losses	3,404,052	7,414,322
Depreciation	2,152,674	1,490,650
Loss on sale of other real estate owned	21,555	13,540
Amortization/accretion of investment premiums/discounts, net	2,377,723	(2,956,678)
Income from NCUSIF	—	(4,225,924)
Impairment of membership capital shares at corporate credit unions	110,974	2,921,034
Changes in operating assets and liabilities:		
Accrued income receivable	690,704	344,340
Prepaid and other assets	1,818,585	(314,877)
Accounts payable and accrued liabilities	473,089	1,848,109
Net cash provided by operating activities	18,234,887	10,797,635
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and repayments of available-for-sale securities	143,998,560	66,071,938
Purchase of available-for-sale securities	(185,407,019)	(206,045,861)
Proceeds from maturities and repayments of held-to-maturity securities	1,565,372	2,041,042
Change in NCUSIF deposit	33,930	(792,009)
Net change in loans, net of charge-offs	(21,357,608)	(28,407,860)
Recoveries on loans charged off	658,987	557,262
Net change in non-negotiable certificates of deposit	60,660,901	108,512,332
Expenditures for property and equipment	(1,492,925)	(3,055,768)
Proceeds from sale of other real estate owned	641,203	249,300
Net cash used in investing activities	(698,599)	(60,869,624)

The accompanying notes are an integral
part of these financial statements.

<p align="center">COMMONWEALTH CREDIT UNION STATEMENTS OF CASH FLOWS</p>

Cash Flows: (continued)

	For the years ended December 31,	
	2010	2009
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in members' share and savings accounts	(8,619,411)	45,971,423
Net cash (used in)/provided by financing activities	(8,619,411)	45,971,423
Net change in cash and cash equivalents	8,916,877	(4,100,566)
Cash and cash equivalents at beginning of year	11,720,225	15,820,791
Cash and cash equivalents at end of year	<u>\$20,637,102</u>	<u>\$11,720,225</u>
SUPPLEMENTAL CASH FLOWS DISCLOSURES:		
Interest paid	<u>\$10,067,709</u>	<u>\$16,267,971</u>
SCHEDULE OF NON-CASH TRANSACTIONS:		
Transfers from loans to members to other real estate owned	<u>\$661,029</u>	<u>\$548,219</u>

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
--

NOTE 1: SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

Commonwealth Credit Union (the "Credit Union") is a cooperative association organized in accordance with Chapter 290 of the Kentucky State Chartered Credit Union Law. Participation in the Credit Union is limited to those individuals that qualify for membership. The field of membership is defined in the Credit Union's Charter and Bylaws.

FINANCIAL STATEMENTS/USE OF ESTIMATES

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP/USA) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the periods then ended. Estimates that are particularly susceptible to change relate to the determination of the allowance for loan losses and the fair value of financial instruments. The significant accounting principles and policies used in the preparation of these financial statements, together with certain related information, are summarized below.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents includes amounts due from banks and credit unions and cash on hand. Amounts due from banks may, at times, exceed federally insured limits.

INVESTMENTS

Investments are classified into the following categories: held-to-maturity and available-for-sale. Investment securities classified as held-to-maturity are measured at amortized cost. This classification is based upon the Credit Union's intent and ability to hold these investment securities to full maturity. Investment securities classified as available-for-sale are measured at market value as of the statement of financial condition date. Unrealized gains and losses for available-for-sale investments are reported as a separate component of members' equity.

FEDERAL HOME LOAN BANK (FHLB) STOCK

As a member of the FHLB, the Credit Union is required to make a minimum stock investment with the FHLB based on a formula developed by the FHLB that considers the Credit Union's total assets and outstanding advances from the FHLB. No ready market exist for the FHLB stock and it has no quoted market price.

MEMBERSHIP CAPITAL SHARES AT CORPORATE CREDIT UNIONS

Kentucky Corporate Credit Union (KyCorp) and Western Corporate Credit Union (WesCorp) require that a restricted capital share deposit be maintained for full participation as a member credit union. The deposit is based on the amount of each member credit union's total assets, and is not insured by the NCUSIF. The balance of restricted membership capital shares as of December 31, 2010 and 2009 was approximately \$692,000 and \$803,000, respectively. (See Note 11)

<p style="text-align: center;">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
--

Note 1: (continued)

LOANS TO MEMBERS AND ALLOWANCE FOR LOAN LOSSES

Loans are stated at the amount of unpaid principal, net of certain deferred fees and costs and an allowance for loan losses. The allowance for loan losses is increased by a provision for loan losses charged to expense and decreased by charge-offs (net of recoveries). The allowance for loan losses is maintained at an amount that represents management's estimate of incurred losses in the outstanding loan portfolio.

Management's periodic evaluation of the adequacy of the allowance account is based on the Credit Union's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and current economic conditions.

Interest on loans is recognized over the terms of the loans and is calculated on principal amounts outstanding. The accrual of interest is discontinued when a loan exceeds 90 days delinquent or when management believes that collection of interest is doubtful. Loan fees which are charged to members and direct origination costs on indirect vehicle loans are deferred and amortized as an adjustment of loan yield over the estimated life of the loan using a method that approximates the interest method. Direct loan origination costs on consumer loans are recognized in expenses when incurred. This is not materially different from expenses that would have been recognized under the provisions of the Nonrefundable Fees and Other Costs Topic of the FASB Accounting Standards Codification.

OTHER REAL ESTATE OWNED

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell.

PROPERTY AND EQUIPMENT

Land is carried at cost. Property and equipment are carried at cost less accumulated depreciation. Buildings, and furniture and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. The cost of leasehold improvements is amortized using the straight-line method over the term of the lease, or the estimated life of the asset, whichever is less. The Credit Union reviews property and equipment (long-lived assets) for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

NCUSIF DEPOSIT

The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with National Credit Union Administration (NCUA) regulations, which require the maintenance of a deposit by each federally insured credit union in an amount equal to 1% of its insured members' shares. The deposit would be refunded to the Credit Union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board.

<p style="text-align: center;">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
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*Note 1: (continued)***NCUA INSURANCE ASSESSMENTS**

During 2009, the NCUA Board assessed a 15.0 basis point insurance premium on insured deposits as of June 30, 2009. During 2010, the NCUA Board assessed a 13.4 basis point insurance premium on insured deposits as of March 31, 2010, and a 12.42 basis point insurance premium on insured deposits as of June 30, 2010. (See Notes 11 and 12)

MEMBERS' SHARE AND SAVINGS ACCOUNTS

Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Interest on members' share and savings accounts is based on available earnings at the end of an interest period and is not guaranteed by the Credit Union. Interest rates on members' share accounts are ratified by the Board of Directors, based on an evaluation of current and future market conditions.

MEMBERS' EQUITY

The Credit Union is required to maintain a statutory reserve (regular reserve) in accordance with the Federal Credit Union Act. This statutory reserve represents a regulatory restriction and is not available for the payment of interest.

FEDERAL AND STATE TAX EXEMPTION

The Credit Union is exempt from most federal, state, and local taxes.

RECLASSIFICATIONS

Certain 2009 financial statement amounts have been reclassified to conform with classifications adopted in 2010.

SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 7, 2011, the date the financial statements were available to be issued. Management has not identified any items requiring recognition or disclosure.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
--

NOTE 2: INVESTMENTS

The amortized cost and estimated market value of investments are as follows:

As of December 31, 2010				
<u>Available-for-sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Federal agency securities	\$182,023,361	\$459,501	(\$268,393)	\$182,214,469
Mortgage-backed securities	77,003,650	1,059,428	(198,695)	77,864,383
	<u>\$259,027,011</u>	<u>\$1,518,929</u>	<u>(\$467,088)</u>	<u>\$260,078,852</u>

As of December 31, 2009				
<u>Available-for-sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Federal agency securities	\$154,119,406	\$902,773	(\$101,828)	\$154,920,351
Mortgage-backed securities	65,868,041	895,155	(570,722)	66,192,474
	<u>\$219,987,447</u>	<u>\$1,797,928</u>	<u>(\$672,550)</u>	<u>\$221,112,825</u>

As of December 31, 2010				
<u>Held-to-maturity:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Mortgage-backed securities	\$1,207,321	\$—	(\$10,338)	\$1,196,983

As of December 31, 2009				
<u>Held-to-maturity:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
Mortgage-backed securities	\$2,781,521	\$10,617	\$—	\$2,792,138

The amortized cost and estimated market value of investments by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay certain obligations without call or prepayment penalties.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
--

Note 2: (continued)

As of December 31, 2010				
	<i>Available-for-sale</i>		<i>Held-to-maturity</i>	
	Amortized Cost	Market Value	Amortized Cost	Market Value
Within 1 year	\$89,758,099	\$90,143,553	\$—	\$—
1 to 5 years	92,265,262	92,070,916	—	—
	182,023,361	182,214,469	—	—
Mortgage-backed securities	77,003,650	77,864,383	1,207,321	1,196,983
	<u>\$259,027,011</u>	<u>\$260,078,852</u>	<u>\$1,207,321</u>	<u>\$1,196,983</u>

The following tables show the gross unrealized losses and fair value of investments, aggregated by length of time that individual securities have been in a continuous unrealized loss position.

As of December 31, 2010						
Available-for-sale						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Federal agency securities	\$99,085,273	(\$268,393)	\$—	\$—	\$99,085,273	(\$268,393)
Mortgage-backed securities	12,075,972	(129,702)	8,428,588	(68,993)	20,504,560	(198,695)
	\$111,161,245	(\$398,095)	\$8,428,588	(\$68,993)	\$119,589,833	(\$467,088)

As of December 31, 2009						
Available-for-sale						
	<i>Less than 12 Months</i>		<i>12 Months or Longer</i>		<i>Total</i>	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Federal agency securities	\$19,895,715	(\$101,828)	\$—	\$—	\$19,895,715	(\$101,828)
Mortgage-backed securities	19,637,126	(570,722)	—	—	19,637,126	(570,722)
	\$39,532,841	(\$672,550)	\$—	\$—	\$39,532,841	(\$672,550)

<p align="center">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
--

Note 2: (continued)

As of December 31, 2010					
<i>Held-to-maturity</i>					
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
					Gross Unrealized Losses
Mortgage-backed securities	\$1,196,983	(\$10,338)	\$—	\$—	\$1,196,983
					(\$10,338)

Unrealized losses on securities issued by the U.S. Government and its agencies have not been recognized into income because the principal balances of these securities are guaranteed by the U.S. Government. Additionally, the decline in the fair values of the investment securities is largely due differences between security yields and market interest rates and the fair values of the securities are expected to be recovered as these securities approach their maturity date and/or market rates decline. Management has the ability to hold these securities until recovery, which may be maturity.

NOTE 3: LOANS TO MEMBERS

The composition of loans to members is as follows:

	As of December 31,	
	2010	2009
Mortgage	\$239,759,172	\$240,439,159
Vehicle	155,438,996	143,199,962
Unsecured	102,904,669	97,523,371
Commercial participation loans	20,049,610	21,164,258
Other secured	6,916,738	6,980,392
	525,069,185	509,307,142
Net deferred fees and costs	614,502	606,572
	525,683,687	509,913,714
Less allowance for loan losses	(5,206,884)	(6,070,451)
	<u>\$520,476,803</u>	<u>\$503,843,263</u>

Loans on which the accrual of interest has been discontinued or reduced approximated \$6,892,000 and \$2,532,400 as of December 31, 2010 and 2009, respectively. If interest on these loans had been accrued, such income would have approximated \$1,246,000 and \$134,000 for the years ended December 31, 2010 and 2009, respectively.

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**
Note 3: (continued)

A summary of the activity in the allowance for loan losses is as follows:

	For the years ended December 31,	
	2010	2009
Balance, beginning of year	\$6,070,451	\$4,415,026
Provision for loan losses	3,404,052	7,414,322
Recoveries	658,987	557,262
Loans charged off	(4,722,242)	(6,316,159)
Loan participation charge off correction	(204,364)	—
Balance, end of year	\$5,206,884	\$6,070,451

NOTE 4: PROPERTY AND EQUIPMENT

A summary of the Credit Union's property and equipment is as follows:

	As of December 31,	
	2010	2009
Land	\$3,863,130	\$3,657,804
Buildings	23,703,139	24,123,767
Furniture and equipment	13,358,342	13,752,480
	40,924,611	41,534,051
Less accumulated depreciation	(19,923,204)	(19,872,895)
	\$21,001,407	\$21,661,156

**NOTE 5: MEMBERS' SHARE AND
SAVINGS ACCOUNTS**

Members' share and savings accounts are summarized as follows:

	As of December 31,	
	2010	2009
Share	\$280,857,663	\$257,211,815
Individual retirement accounts	20,492,274	19,743,944
Money market accounts	99,114,456	96,727,156
Share draft accounts	72,992,674	68,944,620
Certificates of deposit and IRA certificates	245,054,780	284,503,723
	\$718,511,847	\$727,131,258

The aggregate amount of members' individual time deposit accounts in denominations of \$100,000 and over was approximately \$57,534,000 and \$67,341,000 as of December 31, 2010 and 2009, respectively.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 5: (continued)

Scheduled maturities of share and IRA certificates are as follows:

	As of December 31, 2010
Within 1 year	\$166,709,973
1 to 2 years	38,155,388
2 to 3 years	18,075,388
3 to 4 years	4,431,555
4 to 5 years	12,973,596
Thereafter	4,708,880
	\$245,054,780

SHARE INSURANCE

Members' share accounts are insured by the NCUSIF to a maximum of \$250,000 for each member. Individual Retirement Accounts are separately insured to a maximum of \$250,000. The Credit Union also maintains excess share insurance through Excess Share Insurance Corporation which provides an additional amount of share insurance of \$100,000 per account.

NOTE 6: EMPLOYEE BENEFITS

PENSION PLAN

The Credit Union participates in a state sponsored defined benefit pension plan covering substantially all of its employees. For the years ended December 31, 2010 and 2009, contributions and cost were determined as a percentage of each covered employee's compensation, adjusted for forfeitures, and totaled approximately \$1,790,000 and \$1,329,000 for the years ended December 31, 2010 and 2009, respectively.

**NOTE 7: COMMITMENTS AND
CONTINGENT LIABILITIES**

LEASE COMMITMENTS:

The Credit Union had outstanding commitments under operating leases for ATM equipment and servicing as of December 31, 2010. The minimum noncancellable lease obligations approximate the following as of December 31, 2010:

Year ending December 31,	Amount
2011	\$311,000
2012	307,000
2013	119,000
2014	18,000
	\$755,000

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 7: (continued)

Rental expense under operating leases was approximately \$305,000 and \$268,000 for the years ended December 31, 2010 and 2009, respectively.

LINES OF CREDIT

As of December 31, 2010, the Credit Union maintained unused lines of credit with KyCorp and Western Bridge Corporate Federal Credit Union. The KyCorp agreement requires the pledging of all assets as security for obligations under this line-of-credit agreement. The agreement with Western Bridge Corporate Federal Credit Union requires the pledging of specific certificate of deposit investments as security for the obligations under this line-of-credit agreement. The aggregate unused line of credit under these agreements was \$15,000,000 as of December 31, 2010.

As a member of the FHLB, the Credit Union had access to a pre-approved secured line of credit with the capacity to borrow up to a certain percentage of the value of its eligible 1-4 family first mortgage loans, as defined in the FHLB Statement of Credit Policy. The aggregate unused line of credit under this agreement was approximately \$44,835,000 as of December 31, 2010.

***NOTE 8: OFF-BALANCE-SHEET RISK
AND CONCENTRATIONS OF CREDIT RISK***

OFF-BALANCE SHEET RISK:

The Credit Union is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statements of financial condition. Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses.

Since many of the commitments may expire without being fully drawn upon, the total commitment amounts do not necessarily represent future cash requirements. As of December 31, 2010, the total unfunded commitments under such lines of credit was approximately \$232,410,000. The Credit Union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the member.

CONCENTRATIONS OF CREDIT RISK

The Credit Union may be exposed to credit risk from a regional economic standpoint, since a significant concentration of its borrowers work or reside in the state of Kentucky. However, the loan portfolio is well diversified and the Credit Union does not have any significant concentrations of credit risk.

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**
NOTE 9: REGULATORY CAPITAL

The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory-and possibly additional discretionary-actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth (as defined in NCUA's Rules and Regulations) to total assets (as defined in NCUA's Rules and Regulations). Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNWR as of December 31, 2010 and 2009 was 4.84% and 4.92% respectively. The minimum ratio to be considered complex under the regulatory framework is 6.00%. Management believes, as of December 31, 2010 and 2009, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2010, the most recent call reporting period, the NCUA categorized the Credit Union as "*well capitalized*" under the regulatory framework for prompt corrective action. To be categorized as "*well capitalized*" the Credit Union must maintain a minimum net worth ratio of 7.00% of total assets. There are no conditions or events since that notification that management believes have changed the Credit Union's category.

The Credit Union's actual and required net worth amounts and ratios are as follows:

	As of December 31, 2010		As of December 31, 2009	
	Amount	Ratio/ Requirement	Amount	Ratio/ Requirement
Actual net worth	\$152,409,303	17.31%	\$145,223,772	16.48%
Amount needed to be classified as "adequately capitalized"	\$52,813,019	6.00%	\$52,875,078	6.00%
Amount needed to be classified as "well capitalized"	\$61,615,188	7.00%	\$61,687,591	7.00%

Because the RBNWR is less than the net worth ratio, the Credit Union retains its original category of well capitalized. Furthermore in performing its calculation of total assets the Credit Union used the quarter end option, as permitted by regulation.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

***NOTE 10: FAIR VALUES OF FINANCIAL
INSTRUMENTS***

The Credit Union adopted the Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards of Codification, which provides a framework for measuring fair value that requires an entity to derive fair value from the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date within its principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. To increase consistency and comparability in fair value measurements and related disclosures, a three-level hierarchy prioritizes the inputs to valuation techniques used to measure fair value with the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3) as further described below:

Level 1

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Credit Union has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include: quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are inactive; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3

Level 3 inputs are unobservable inputs for the asset or liability which reflect the Credit Union's own assumptions about the assumptions that market participants would use in pricing the asset or liability. Assumptions about risk include risk inherent in a particular valuation technique used to measure fair value, typically pricing models and/or discounted cash flow methodologies.

The methodologies and associated inputs used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While the Credit Union believes its valuation methods and associated inputs are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 10: (continued)

The following tables set forth by level, within the fair value hierarchy, the Credit Union's financial instruments at fair value:

Assets at Fair Value as of December 31, 2010				
	Quoted Prices in Active Markets Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Level 1	Level 2	Level 3	Total
Assets:				
Federal agency securities	\$182,214,469	\$—	\$—	\$182,214,469
Mortgage-backed securities	77,864,383	—	—	77,864,383
	<u>\$260,078,852</u>	<u>\$—</u>	<u>\$—</u>	<u>\$260,078,852</u>

Assets at Fair Value as of December 31, 2009				
	Quoted Prices in Active Markets Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Level 1	Level 2	Level 3	Total
Assets:				
Federal agency securities	\$154,920,351	\$—	\$—	\$154,920,351
Mortgage-backed securities	66,192,474	—	—	66,192,474
	<u>\$221,112,825</u>	<u>\$—</u>	<u>\$—</u>	<u>\$221,112,825</u>

The estimated fair value amounts have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of amounts that could be realized in a market exchange. The use of different assumptions and estimation methodologies may have a material effect on the estimated fair value amounts. The following methods and assumptions were used to estimate fair value of each of the financial instruments for which it was practicable to estimate.

CASH AND CASH EQUIVALENTS/NON-NEGOTIABLE CERTIFICATES OF DEPOSIT

The carrying amount is a reasonable estimation of fair value due to the short-term nature of these instruments.

INVESTMENTS

Estimated fair values of investments are obtained from quoted market prices where available.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 10: (continued)

LOANS TO MEMBERS

The estimated fair value of variable-rate loans is the current carrying amount. The fair value of fixed-rate loans was estimated by discounting the estimated cash flows using the current rate at which similar loans would be issued.

ACCRUED INCOME RECEIVABLE

The carrying amount is a reasonable estimation of fair value.

MEMBERS' SHARE AND SAVINGS ACCOUNTS

The estimated fair value of demand deposit accounts (regular share, share draft, and money market accounts, etc.) is the carrying amount. The fair value of fixed-rate certificates was estimated by discounting the estimated cash flows using the current rate at which similar certificates would be issued.

COMMITMENTS TO EXTEND CREDIT

The fair value of commitments to extend credit is equivalent to the amount of credit extended since the Credit Union does not charge fees to enter into these commitments and the commitments are not stated at fixed rates.

The carrying value and estimated fair value of the Credit Union's financial instruments are as follows:

	As of December 31, 2010		As of December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<i>Financial assets:</i>				
Cash and cash equivalents	\$20,637,102	\$20,637,102	\$11,720,225	\$11,720,225
Non-negotiable certificates of deposit	\$39,908,298	\$39,908,298	\$100,569,199	\$100,569,199
Investments:				
Available-for-sale	\$260,078,852	\$260,078,852	\$221,112,825	\$221,112,825
Held-to-maturity	\$1,207,321	\$1,196,983	\$2,781,521	\$2,792,138
Loans to members, net	\$520,476,803	\$526,458,224	\$503,843,263	\$519,829,286
Accrued interest receivable	\$3,329,212	\$3,329,212	\$4,019,916	\$4,019,916
<i>Financial liabilities:</i>				
Members' share and savings accounts	\$718,511,847	\$723,124,608	\$727,131,258	\$713,808,230
<i>Unrecognized financial instruments:</i>				
Commitments to extend credit	\$—	\$232,410,000	\$—	\$230,623,000

<p>COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
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***NOTE 11: NCUA CORPORATE
STABILIZATION PROGRAM***

In January 2009, the NCUA informed federally-insured credit unions that it was taking actions to enhance and support the corporate credit union system as well as the NCUSIF. In addition to placing U.S. Central Federal Credit Union and two other corporate credit unions into conservatorship, the NCUA established the Temporary Corporate Credit Union Share Guarantee Program, whereby all deposits in excess of insurable limits maintained at corporate credit unions, other than membership capital shares and paid-in capital, will be guaranteed through December 31, 2012. The actions taken in January 2009 resulted in a 69% write-down of the Credit Union's 1 percent NCUSIF deposit and the assessment of an insurance premium. The Credit Union recognized the 69% impairment of the NCUSIF deposit of approximately \$4,226,000 during the year ended December 31, 2008, and the 15 basis point insurance premium assessment of approximately \$1,089,000 during the year ended December 31, 2009.

NOTE 12: INDUSTRY EVENTS

The losses recognized by many natural person credit unions from their at-risk investments in corporate credit unions, coupled with high loan losses and other non-corporate investment losses, resulted in regulatory actions by the NCUA, including conservatorship, assisted mergers, and liquidations. All of these factors have contributed to significant losses to the NCUSIF and resulted in the assessment of insurance premiums by the NCUA Board during 2009 and 2010 to increase the NCUSIF's equity ratio to above 1.20%.

During May 2009, legislation was created to establish a Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) to absorb the corporate stabilization costs by borrowing money from the U.S. Treasury. As a result of this legislation, the NCUA Board lowered its original insurance premium assessment announced in January 2009 from 30 to 15 basis points and fully restored the NCUSIF deposit that had been impaired by 69%. As a result, the Credit Union recognized non-interest income from the NCUSIF of approximately \$4,226,000 (the same amount as the impairment of the NCUSIF deposit) during the year ended December 31, 2009.

During September 2010, the NCUA received approval from the U.S. Treasury to extend the life of the Stabilization Fund to June 2021. The funds borrowed from the U.S. Treasury will be repaid from assessments authorized by the NCUA Board. The NCUA Board has levied assessments during 2009 and 2010 to repay borrowed funds to the U.S. Treasury. It is anticipated that the NCUA Board will be making annual assessments over at least the next five years to cover costs associated with the corporate credit union system.

★★★★★★

Advisory Groups

Several Advisory Groups were formed early 2010. They met throughout the year to help us enhance our current products and to give insight on future products and services. There were three groups; one in Frankfort, Lawrenceburg, and Lexington.

In addition to these three groups two Gen-Y Advisory Groups were formed, one in Frankfort and one in Lexington. These groups were comprised of members between the ages of 19-35 and met several times to help us enhance our current products and to give insight on future products and services that would tailor to their specific needs.



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Treasurer's Report

Following the lowest financial performance year in our history, 2010 experienced stronger earnings compared to last year and to the 2010 aggregate pool of credit unions in our asset size. Decisions made last year, to move our deposit rates from the higher than market position we prefer to pay to a more moderate position, lead the way. Historically low earnings on our investments and lower than recent years loan demand precipitated the change. Deposit growth was closely managed, and for the second year this century our asset growth modestly declined.

Total shares at all US credit unions increased around 3% while loans outstanding declined about 1% for 2010.

Non-interest income was up 8% over last year due to higher interchange income resulting from growth in the number of member debit and credit card transactions. The 2009 \$4.2M NCUSIF Recapitalization Deposit due to Congressional action related to Corporate Credit Union impairment expenses stands out on the income statement comparison. It is not an item likely to ever be repeated.

We paid \$2M (million) to NCUA for federal share insurance and for our share of the cost to preserve the Corporate Credit Union System. A similar payment is expected for 2011. This expense, in addition to expenses and reduced income resulting from recent and anticipated future legislation, will continue influence member product and service changes.

Our newest branch location on US 127 in Lawrenceburg contributed to a huge 30% increase in new members. It was also the primary contributor to higher non-interest expenses. Apart from the new branch, steps were successfully taken to reduce operational expenses. Loan losses were 54% lower than the record high losses experienced last year.

There will be new interest rate and regulatory driven challenges to navigate in 2011. We are positioned to continue to provide you with the best financial services available. Many media financial advisors are proclaiming the attributes of credit union membership. We're glad you recognize the tremendous source of financial resources Commonwealth Credit Union provides members. Encourage your family members to join. Thank you for allowing us to serve you. We will to continue to do what it takes to earn your business.

Jim R. Chadwell, Jr.
Secretary/Treasurer

Financial Report

BALANCE SHEET

ASSETS	2010*	2009
Cash	\$ 5,441,227	\$ 4,585,436
Investments	318,793,632	335,404,338
Loans to Members	519,862,301	503,254,215
Fixed Assets	21,001,407	21,661,155
Other Assets	15,118,411	16,346,162
TOTAL	\$880,216,978	\$881,251,306
LIABILITIES & EQUITY		
Other Liabilities	\$ 8,243,986	\$ 7,770,895
Member Shares	718,511,848	727,131,257
Member Equity	153,461,144	146,349,154
TOTAL	\$880,216,978	\$881,251,306

INCOME STATEMENT

	2010*	2009
Interest Income		
Interest on Loans	\$ 34,026,440	\$ 34,564,349
Interest on Investments	6,674,048	10,126,901
Total Interest Income	\$ 40,700,488	\$ 44,691,250
Plus:		
Non-Interest Income	\$ 10,680,073	\$ 9,897,724
Minus:		
Non-Interest Expenses	30,682,455	27,952,297
Cost of Funds	10,067,709	16,264,123
Provision for Loan Losses	3,404,052	7,414,322
Plus (Minus):		
Non-Operating Gains (Loss)	(40,815)	(2,921,034)
Net Income	\$ 7,185,530	\$ 4,263,123
*Unaudited		

Fair Value of Financial Instruments

Description	As Of 12/31/2010		As Of 12/31/2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash & Short Term Invest	\$21,329,088	\$ 21,329,088	\$13,814,931	\$ 13,814,931
Trading Account	0	0	0	0
Investment Securities	302,000,771	302,895,453	326,174,843	398,707,901
Loans	521,000,185	509,334,665	500,334,665	
Allow. For Loan Losses	(1,206,894)	(6,070,450)		
Net Loans	519,793,291	503,264,215	500,334,665	525,899,373
Total Financial Assets	\$844,097,164	\$834,499,196	\$840,349,999	\$938,422,204
Financial Liabilities				
Deposits	\$718,511,848	\$723,131,898	\$727,131,257	\$713,898,230
Short Term Borrowings	0	0	0	0
Securities Sold Not Closed	0	0	0	0
Total Financial Liabilities	\$718,511,848	\$723,131,898	\$727,131,257	\$713,898,230



2010
Annual Report

COMMONWEALTH
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Common Goals,
UNCOMMON SERVICE.

Annual Meeting Agenda

Roll Call.....	John C. Scott
Elections.....	John C. Scott
Board of Directors Report.....	John C. Scott
Secretary/Treasurer Report.....	Jim Chadwell
Supervisory Committee Report.....	Kathleen Rodgers
President's Report.....	Gary Wallace
New Business.....	John C. Scott
Adjournment.....	John C. Scott

BOARD OF DIRECTORS

John C. Scott.....	Chairperson
Bob Bender.....	Vice Chairperson
Jim Chadwell.....	Secretary/Treasurer
Gary Wallace.....	President
Randy Fawns.....	Director
Mary Foster.....	Director
Regina Grubbs.....	Director
Robin Brewer.....	Director
Kay Jones.....	Director
Bill Leach.....	Director
Randy Overstreet.....	Director
Alex Rose.....	Director
Harry Suter.....	Director

SUPERVISORY COMMITTEE

Kathleen Rodgers.....	Chairperson
Jane Cheshire Gilbert.....	Vice Chairperson
Steve Dooley.....	Member
Gary Forman.....	Member
Kenneth E. Blackwell Jr.....	Member

Board of Director's Report

The first year of the second decade of the 21st century saw a continuation of the ups and downs and uncertainty that has plagued the financial sector for the past few years.

Fortunately, Commonwealth Credit Union has maintained a very strong financial position that has enabled us to continue providing the best possible financial services to our members/owners.

While the news media has been filled with bleak stories of bank failures, mergers and bailouts, your credit union looked upon this period as a time of opportunity.

Specifically, we saw this as an occasion to recommit ourselves to helping our members, who are on the front lines facing the problems affecting our city, state and nation.

We are proud of the efforts our staff has made in helping our members with the various financial difficulties they may have experienced. We are extremely excited about the upcoming year and the fact that we are in a position to continue to help our members to better themselves financially.

This is just one way we are helping our members and putting our motto of "Common Goals, UNCOMMON SERVICE" into practice.

On behalf of the entire Board, I want to, once again, thank all our staff for the hard work and dedication they have shown in serving our members/owners this year, and also thank all our members/owners for allowing us the privilege of serving their financial needs.

John C. Scott
Board Chairperson

President's Report

While the global economy caused many financial institutions to scale back in 2010, we again showed our commitment to our members by launching new products and services. These include:

1) Lawrenceburg Branch. This was a very exciting time for our members in the Lawrenceburg area. The branch opened in February and caters to members in Lawrenceburg and surrounding areas.

2) Scholarship Program. We expanded our Scholarship Program to include four scholarships. One of these scholarships was titled the Adam Bender "Reach for Excellence" scholarship that was awarded to a graduating high school senior that has overcome a physical or mental challenge in their life.

3) ATMs. In October we were able to roll out the new feature of Envelope Free Deposits to the ATMs we own. Members can deposit their checks and cash directly without having to fill out a deposit slip or envelope. Conversion to a new card processor brought greater efficiency to the credit union and services to our members, including repinning cards at ATMs.

4) Online IRAs. Members were given the option to open Individual Retirement Accounts (IRAs) and retrieve all IRA forms online via our website.

5) "IDEcide" Financial Program. This program was started to help our members that were looking for financial information or needed help with a specific financial goal. It combined information from BALANCE, financial seminars, blogs, videos and other website tools to help our members achieve financial success.

As you can see, 2010 was a year full of new products and services, as well as competitive certificates, loan rates and specials. As we celebrate our 60th Anniversary, 2011 promises to be full of the same excitement and challenges that will ensure Commonwealth Credit Union continues to grow and remain one of the top credit unions in the nation.

Gary Wallace
President

Supervisory Committee Report

The Supervisory Committee consists of five members appointed by the Board of Directors. The Committee's main duties are to conduct a comprehensive annual audit of the credit union and other audits as necessary. The Committee also performs a financial and management oversight role, independent of the Board of Directors, on behalf of the credit union membership.

The Committee retained the services of Doeren Mayhew, an independent CPA firm specializing in credit union audits, to conduct the 2009 audit. The credit union was given an unqualified or clean opinion for the 2009 financial statements. A copy of this audit report may be reviewed upon request. The firm of Orth, Chakler, Murnane and Co. will conduct the 2010 audit which should be available for review in the spring of 2011.

In addition to the annual audit, a team of internal auditors, who report directly to the Committee, has developed a flexible annual audit plan using appropriate risk-based methodology to conduct audits of the credit union. During 2010, the Internal Audit staff completed and issued audit reports in numerous areas. The Internal Auditors' main responsibilities are to assist the Committee in ensuring that internal controls are in place and operating as intended, member assets are being safeguarded, and credit union policies and procedures are followed.

We encourage members and credit union employees to express any concerns to the Committee. The names of those expressing concerns will be held in the strictest confidence by the Committee.

The Committee wishes to thank the Board of Directors and the staff of Commonwealth Credit Union for their assistance and cooperation in 2010.

Kathleen Rodgers
Supervisory Committee Chairperson

Advisory Groups

Several Advisory Groups were formed early in 2011. They met throughout the year to help us enhance our current products and to give insight on future products and services. There were three groups; one each in Frankfort, Lawrenceburg, and Lexington.

In addition to these three groups, two Gen-Y Advisory Groups were formed, one in Frankfort and one in Lexington. These groups were comprised of members between the ages of 19-35 and met several times to help us enhance our current products and to give insight on future products and services that would tailor to their specific needs.



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UNCOMMON SERVICE.

Treasurer's Report

As has been the case the past two years, 2011 continued the trend of low market rates in all financial areas. We maintained our position within the market for share rates but made adjustments on the loan side to be more competitive in the mortgage market. We experienced stronger earnings compared to last year and to the 2011 aggregate pool of credit unions in our asset size.

Total shares at all US credit unions increased around 7% while loans outstanding grew about 2% for 2011.

For the second year in a row, we surpassed the average loan growth in both our asset size and in the Top 100 credit unions. Loan growth improved over 2010, finishing 2011 at 3.5%. Loan losses were down from the previous year at 0.6% and delinquency held steady at 0.9%.

Share growth was up slightly at 1% after negative growth in 2010. We continue to offer a secure location for our members to keep their deposits and offer superior member service.

Non-interest income was up 11% over last year due to an increase in NSF/ODP income resulting from an increase in the fee per item. Interchange income also added a positive growth with additional card usage on the checking and credit sides. Non-interest expenses grew slightly by 1% as salaries and employee expenses remained relatively flat for 2011.

We paid \$1.8M (million) to NCUA for federal share insurance and for our share of the cost to preserve the Corporate Credit Union System. A similar payment is expected for 2012.

There will be new interest rate and regulatory driven challenges to navigate in 2012. We are positioned to continue to provide you with the best financial services available. Many media financial advisors are proclaiming the attributes of credit union membership. We're glad you recognize the tremendous source of financial resources Commonwealth Credit Union provides members. Encourage your family members to join. Thank you for allowing us to serve you. We will continue to do what it takes to earn your business.

Jim Chadwell, CPA
Secretary/Treasurer

Financial Report

BALANCE SHEET

ASSETS	2011*	2010
Cash	\$ 5,388,791	\$ 5,441,227
Investments	317,448,868	318,793,632
Loans to Members	537,834,882	519,862,301
Fixed Assets	19,133,725	21,001,407
Other Assets	17,198,735	15,118,411
TOTAL	\$897,005,001	\$880,216,978
LIABILITIES & EQUITY		
Other Liabilities	\$ 8,869,221	\$ 8,243,986
Member Shares	725,625,623	718,511,847
Member Equity	162,510,157	153,461,144
TOTAL	\$897,005,001	\$880,216,978

INCOME STATEMENT

	2011*	2010
Interest Income		
Interest on Loans	\$ 34,112,363	\$ 34,026,440
Interest on Investments	3,746,197	6,674,048
Total Interest Income	\$ 37,858,560	\$ 40,700,488
Plus:		
Non-Interest Income	\$ 11,868,808	\$ 10,680,073
Minus:		
Non-Interest Expenses	30,772,147	30,682,455
Interest Expense	6,026,161	10,067,710
Provision for Loan Losses	3,684,692	3,404,052
Plus (Minus)		
Non-Operating Gains (Loss)	\$ 2,247	(40,815)
Net Income	\$ 9,296,616	\$ 7,185,527
*Unaudited		

Fair Value of Financial Instruments

Description	As Of 12/31/2011		As Of 12/31/2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash & Short Term Invest	\$17,402,349	\$ 17,402,349	\$21,329,013	\$ 21,329,013
Trading Account	0	0	0	0
Investment Securities	283,435,290	284,611,052	302,905,771	302,895,433
Loans	543,507,707		525,068,181	
Allow For Loan Losses	(5,672,824)		(5,206,884)	
Net Loans	\$12,814,883	\$18,404,168	\$11,861,297	\$16,688,549
Total Financial Assets	\$866,673,542	\$880,408,214	\$844,097,081	\$850,882,678
Financial Liabilities				
Deposits	\$725,625,623	\$729,837,460	\$718,511,848	\$723,138,898
Short Term Borrowings	0	0	0	0
Securities Sold Not Purchased	0	0	0	0
Total Financial Liabilities	\$725,625,623	\$729,837,460	\$718,511,848	\$723,138,898



2011
Annual Report

COMMONWEALTH
CREDIT UNION

Common Goals,
UNCOMMON SERVICE.

Annual Meeting Agenda

Roll Call.....	John C. Scott
Elections.....	John C. Scott
Board of Directors Report.....	John C. Scott
Secretary/Treasurer Report.....	Jim Chadwell
Supervisory Committee Report.....	Kenneth E. Blackwell Jr.
President's Report.....	Gary Wallace
New Business.....	John C. Scott
Adjournment.....	John C. Scott

BOARD OF DIRECTORS

John C. Scott.....	Chairperson
Bob Bender.....	Vice Chairperson
Jim Chadwell.....	Secretary/Treasurer
Gary Wallace.....	President
Randy Fawms.....	Director
Mary Foster.....	Director
Regina Grubbs.....	Director
Robin Brewer.....	Director
Kay Jones.....	Director
Bill Leach.....	Director
Randy Overstreet.....	Director
Alex Rose.....	Director
Harry Suter.....	Director

SUPERVISORY COMMITTEE

Kenneth E. Blackwell Jr.	Chairperson
Gary Forman.....	Vice Chairperson
Kathleen Rodgers.....	Member
Steve Dooley.....	Member
Michelle Sutton.....	Member

Board of Director's Report

The first year of the second decade of the 21st century saw a continuation of the ups and downs and uncertainty that has plagued the financial sector for the past few years.

Fortunately, Commonwealth Credit Union has maintained a very strong financial position that has enabled us to continue providing the best possible financial services to our members/owners.

While the news media has been filled with bleak stories of bank failures, mergers and bailouts, your credit union looked upon this period as a time of opportunity.

Specifically, we saw this as an occasion to recommit ourselves to helping our members, who are on the front lines facing the problems affecting our city, state and nation.

We are proud of the efforts our staff has made in helping our members with the various financial difficulties they may have experienced. We are extremely excited about the upcoming year and the fact that we are in a position to continue to help our members to better themselves financially.

This is just one way we are helping our members and putting our motto of "Common Goals, UNCOMMON SERVICE" into practice.

On behalf of the entire Board, I want to, once again, thank all our staff for the hard work and dedication they have shown in serving our members/owners this year, and also thank all our members/owners for allowing us the privilege of serving their financial needs. I would also like to take this time to thank Mr. Wallace for his service and leadership to the credit union for the past 35 years. The strong financial condition and smooth management transition at his retirement are truly a testament to his vision as a leader.

John C. Scott
Board Chairperson

President's Report

While the global economy caused many financial institutions to scale back in 2011, we again showed our commitment to our members by launching new products and services. These include:

1) RoundUP Checking Accounts. We were able to offer this exciting new checking account product that allowed our members to save money just by using their debit card. Many members took advantage of this account and it is still a popular account.

2) EZSign for Members. In 2011 we offered members a more convenient way to sign loan documents, etc. for those that were not able to come to a branch. EZSign allowed the member to electronically sign their documents, which made it possible to provide faster and better member service.

3) New Bill Pay Provider. In July we transitioned to a new Bill Pay Provider. This switch gave us more features for members to utilize, as well as the ability of using Bill Pay via a mobile device in the future. This was important with the introduction of our new mobile site and for mobile apps in the near future.

4) Mobile Apps/New Mobile Banking Site. We introduced a more robust Mobile Banking site and mobile banking apps the first part of December. This added convenience allows members to check their balances on the go, transfer money, find locations and so much more. With today's society being "on the go", this service has become very popular with our members.

As you can see, 2011 was a year full of new products and services, as well as competitive certificates, loan rates and specials. As we continue forward, 2012 promises to be full of the same excitement and challenges that will ensure Commonwealth Credit Union continues to grow and remain one of the top credit unions in the nation.

Gary Wallace
President

Supervisory Committee Report

The Supervisory Committee consists of five members appointed by the Board of Directors. The Committee's main duties are to conduct a comprehensive annual audit of the credit union and other audits as necessary. The Committee also performs a financial and management oversight role, independent of the Board of Directors, on behalf of the credit union membership.

The Committee retained the services of Orth, Chakler, Murnane and Co., an independent CPA firm specializing in credit union audits, to conduct the 2010 audit. The credit union was given an unqualified or clean opinion for the 2010 financial statements. A copy of this audit report may be reviewed upon request. The firm of Orth, Chakler, Murnane and Co. will once again conduct the 2011 audit which should be available for review in the spring of 2012.

In addition to the annual audit, a team of internal auditors, who report directly to the Committee, has developed a flexible annual audit plan using appropriate risk-based methodology to conduct audits of the credit union. During 2011, the Internal Audit staff completed and issued audit reports in numerous areas. The Internal Auditors' main responsibilities are to assist the Committee in ensuring that internal controls are in place and operating as intended, member assets are being safeguarded, and credit union policies and procedures are followed.

We encourage members and credit union employees to express any concerns to the Committee. The names of those expressing concerns will be held in the strictest confidence by the Committee.

The Committee wishes to thank the Board of Directors and the staff of Commonwealth Credit Union for their assistance and cooperation in 2011.

Kenneth E. Blackwell, Jr., CPA, CIA
Supervisory Committee Chairperson

Advisory Groups

Several Advisory Groups were formed early in 2012. They met throughout the year to help us enhance our current products and to give insight on future products and services. There were two groups; one each in Frankfort and Lexington.

In addition to these groups, two Gen-Y Advisory Groups were formed, one in Frankfort and one in Lexington. These groups were comprised of members between the ages of 19-30 and met several times to help us enhance our current products and to give insight on future products and services that would tailor to their specific needs.

Lastly, we had internal associate groups that worked alongside these Advisory Groups and management to form the LEAP Program, as well as confer with us on other products and services to help with their success and make sure they met our members' needs.



COMMONWEALTH
CREDIT UNION

Common Goals,
UNCOMMON SERVICE.

Treasurer's Report

A low interest rate market continued throughout 2012 and is expected to extend out to mid-2014. We maintained our market position for share rates; and, lowered mortgage loan rates to a more competitive market position. In the last quarter of the year, we added a cash back credit card option. Many members have asked for this option and we are pleased to make it available to you.

We experienced stronger earnings compared to last year and to the aggregate pool of credit unions in our asset size. These earnings make possible state of the art technology, like mobile banking, remote deposit, and online mortgage applications, three of our newer services members are using with lots of positive feedback.

Total shares at all US credit unions increased 6% while loans outstanding grew 4%. Commonwealth share and loan growth was 2.3%. The highest loan growth in dollars was mortgage loans followed by unsecured member loans. Loan losses to average loans were up modestly ending at .63% (and lower than similar size credit unions, .67%). Delinquency ended higher than last year (.87%) at 1.08%.

Share growth at 2.3% was up compared to last year's growth rate of 1%. The highest dollar growth was in our High Yield Savings accounts. Members also added checking accounts as we added checking account products and made check cashing more convenient with mobile remote deposit.

Non-interest income was up 3.6% over last year due primarily to sales of insurance products. Non-interest expenses declined 4.3% due to lower employee compensation and regulatory expenses.

We continue to be one of the most solvent credit unions in the U.S. Our capital position is far higher than the average financial institution making us one of the safest places in the nation for depositors.

Interest rates for 2013 are expected to remain flat and regulatory requirements are expected to increase operational expenses. We plan to open additional branches and ATM sites to serve member loan and share needs. Many media financial advisors continue to attest to the positive attributes of credit union membership. We're glad you recognize the tremendous source of financial resources Commonwealth Credit Union provides members. Please encourage your family members to benefit by joining. We constantly and consistently strive to earn your business. Thank you for allowing us to serve you.

Jim Chadwell, CPA
Secretary/Treasurer

Financial Report

BALANCE SHEET

ASSETS	2012*	2011
Cash & Overnight	\$ 48,378,035	\$ 36,710,383
Investments	292,639,892	285,435,290
Loans to Members	550,349,290	538,537,221
Fixed Assets	19,209,734	19,133,725
Other Assets	17,454,490	17,188,382
TOTAL	\$928,031,441	\$897,005,001
LIABILITIES & EQUITY		
Other Liabilities	\$ 9,751,571	\$ 8,869,221
Member Shares	742,359,541	725,625,623
Member Equity	175,920,329	162,510,157
TOTAL	\$928,031,441	\$897,005,001

INCOME STATEMENT

	2012*	2011
Interest Income		
Interest on Loans	\$ 34,958,046	\$ 34,112,363
Interest on Investments	2,987,387	3,746,197
Total Interest Income	\$ 37,945,433	\$ 37,858,560
Plus:		
Non-Interest Income	\$ 12,294,134	\$ 11,921,055
Minus:		
Non-Interest Expenses	29,443,438	30,772,147
Interest Expense	3,999,159	6,026,161
Provision for Loan Losses	3,280,672	3,684,692
Plus (Minus):		
Non-Operating Gains (Loss)	(286,762)	-
Net Income	\$ 13,229,536	\$ 9,296,615
*Unaudited		

Fair Value of Financial Instruments

Description	As Of 12/31/2012		As Of 12/31/2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash & Short Term Invest	\$48,378,035	\$ 48,378,035	\$37,402,369	\$ 37,402,369
Trading Account	0	0	0	0
Investment Securities	292,639,891	292,639,891	283,723,990	282,919,752
Loans	551,818,342		543,907,797	
Allow. For Loan Losses	(15,500,654)		(15,677,924)	
Net Loans	536,317,688	531,171,768	528,229,873	528,229,873
Total Financial Assets	\$928,031,441	\$897,005,001	\$897,005,001	\$897,005,001
Financial Liabilities				
Deposits	\$742,359,541	\$741,857,391	\$725,625,623	\$725,625,623
Short Term Borrowings	0	0	0	0
Securities Sold Not Owned	0	0	0	0
Total Financial Liabilities	\$742,359,541	\$741,857,391	\$725,625,623	\$725,625,623



2012 Annual Report



COMMONWEALTH
CREDIT UNION

Common Goals,
UNCOMMON SERVICE.

Annual Meeting Agenda

Roll Call.....	John C. Scott
Elections.....	John C. Scott
Board of Directors Report.....	John C. Scott
Secretary/Treasurer Report.....	Jim Chadwell
Supervisory Committee Report.....	Kenneth E. Blackwell Jr.
President's Report.....	Karen Harbin
New Business.....	John C. Scott
Adjournment.....	John C. Scott

BOARD OF DIRECTORS

John C. Scott.....	Chairperson
Bob Bender.....	Vice Chairperson
Jim Chadwell.....	Secretary/Treasurer
Karen Harbin.....	President
Randy Fawns.....	Director
Mary Foster.....	Director
Regina Grubbs.....	Director
Robin Brewer.....	Director
Kay Jones.....	Director
Bill Leach.....	Director
Randy Overstreet.....	Director
Alex Rose.....	Director
Harry Suter.....	Director

SUPERVISORY COMMITTEE

Kenneth E. Blackwell Jr.	Chairperson
Gary Forman.....	Vice Chairperson
Kathleen Rodgers.....	Member
Steve Dooley.....	Member
Michelle Sutton.....	Member

Board of Director's Report

With the passing of time comes change. It's inevitable, whether it's the transitioning of seasons or moving through the stages of life. While change can cause concern with some, change can be a very good thing.

One of our first changes for 2012 was Karen Harbin becoming President of Commonwealth Credit Union. This was a big change. Karen has done a tremendous job and we are seeing the results of her vision and are more committed than ever to serving our member's everchanging needs.

Change allows us to expand and grow. It gives us the ability to open new branches, like our Georgetown Branch, scheduled to open Spring 2013. It also gives us the ability to grow with our members, through the advancements in technology. We have made several advances in cutting edge technology to expand our online services. We enhanced our Online Banking to give members extra opportunities, flexibility and security, including mobile Bill Pay and Mobile Deposit. We are also making plans to introduce an online personal financial manager.

This past year has truly been an exciting time, and we are proud of our staff for their efforts of rolling with the changes, offering ideas, and helping us implement these changes for the betterment of our members and our credit union. This is just the start of many good things that are ahead for us.

On behalf of the entire Board, I want to, once again, thank all our staff for the hard work and dedication they have shown in serving our members/owners this year, and also thank all our members/owners for allowing us the privilege of serving their financial needs.

John C. Scott
Board Chairperson

President's Report

We continued to show our commitment to our members in 2012. We worked on and launched several new products and services. These include:

1) New Credit Card and Rewards. We launched the MYCard credit card and the Commonwealth Rewards program for our credit cards in 2012. MYCard was implemented with exciting new features for our credit card members.

2) LEAP Program. In 2012 we implemented a program for our 13-31 year old members. Our LEAP program is designed to go "Beyond Banking" and provide accounts and services to these members that they cannot receive anywhere else, as well as special benefits, such as free admission to special events. Many members have converted their existing accounts to a LEAP account, and new memberships are being opened to make this a popular program for our young members.

3) Upgrade to Online Banking. In August, we upgraded our Online Banking. This allowed our members the convenience of customizing their Online Banking experience, as well as added security and features that we previously did not have with our other Online Banking vendor.

4) Mobile Deposit Capability with Mobile App. We were able to enhance our mobile banking services further with the technology of Mobile Deposit. This enabled our members with online banking and our mobile app to deposit a check instantly with their smartphone. With today's society being "on the go," this service has become very popular with our members, and will continue to grow and adapt with our members' needs.

As you can see, 2012 was a year full of new products and services, as well as a new program dedicated to our younger members. As we continue forward, 2013 promises to be full of the same excitement and challenges that will ensure Commonwealth Credit Union continues to grow and remain one of the top credit unions in the nation.

Karen Harbin, CPA
President

Supervisory Committee Report

The Supervisory Committee consists of five members appointed by the Board of Directors. The Committee's main duties are to conduct a comprehensive annual audit of the credit union and other audits as necessary. The Committee also performs a financial and management oversight role, independent of the Board of Directors, on behalf of the credit union membership.

The Committee retained the services of Orth, Chakler, Murnane and Co., an independent CPA firm specializing in credit union audits, to conduct the 2011 audit. The credit union was given an unqualified or clean opinion for the 2011 financial statements. A copy of this audit report may be reviewed upon request. The firm of Orth, Chakler, Murnane and Co. will once again conduct the 2012 audit which should be available for review in the spring of 2013.

In addition to the annual audit, a team of internal auditors, who report directly to the Committee, has developed a flexible annual audit plan using appropriate risk-based methodology to conduct audits of the credit union. During 2012, the Internal Audit staff completed and issued audit reports in numerous areas. The Internal Auditors' main responsibilities are to assist the Committee in ensuring that internal controls are in place and operating as intended, member assets are being safeguarded, and credit union policies and procedures are followed.

We encourage members and credit union employees to express any concerns to the Committee. The names of those expressing concerns will be held in the strictest confidence by the Committee.

The Committee wishes to thank the Board of Directors and the staff of Commonwealth Credit Union for their assistance and cooperation in 2012.

Kenneth E. Blackwell, Jr., CPA, CIA
Supervisory Committee Chairperson

Advisory Group Report

Several Advisory Groups met throughout the year to help us enhance our current products and to give insight on future products and services. There were three groups; one each in Frankfort, Georgetown and Lexington.

In addition to these groups, two **Gen-Y Advisory Groups** met in Frankfort and in Lexington. These groups were comprised of members between the ages of 19-30 and met several times to help us enhance our current products and to give insight on future products and services that would tailor to their specific needs.

Lastly, we had internal associate groups that worked alongside these Advisory Groups and management to provide input on the LEAP Program, as well as confer with us on other products and services to help with their success and make sure they met our members' needs.



New branches in Georgetown and the Hamburg area of Lexington were highlights of 2013.

Treasurer's Report

A low interest rate market continued throughout 2013 and is expected to extend out to mid-2014. We had strong loan growth especially in the secured loan area and solid share growth which increased our assets by \$16 million, or 1.7%.

We experienced strong earnings compared to the aggregate pool of credit unions in our asset size. These earnings make possible improved delivery systems to our members. In 2013 we rolled out our mobile deposit, pending transactions, on mobile app, personal financial manager, and online chat services to enhance the member's online experience. We also opened two new branches, one in Georgetown in June and one in Hamburg /Lexington area in late December to better serve members in those areas.

Commonwealth loan growth was 6.5% compared to last year. The highest loan growth in dollars was mortgage loans followed by secured member loans. Loan losses to average loans were up modestly ending at 0.90%. Delinquency ended higher than last year (1.08%) at 1.28%.

Share growth was 1.9% compared to last year. The highest dollar growth was in our High Yield Savings accounts. Members also added checking accounts as we added checking account products and made check deposit more convenient with mobile banking.

Non-interest income was up 2.79% over last year due primarily to increased interchange fees and sales of insurance products. Non-interest expenses increased 9.21% due to higher employee compensation, depreciation and marketing expenses.

We continue to be one of the most solvent credit unions in the U.S. Our capital position is far higher than the average financial institution making us one of the safest places in the nation for members/depositors.

Interest rates for 2014 are expected to rise slightly and regulatory requirements are expected to increase operational expenses. We plan to open additional branches to serve member loan and share needs. Many media financial advisors continue to attest to the positive attributes of credit union membership. We're glad you recognize the tremendous source of financial resources Commonwealth Credit Union provides members. Please encourage your family members to benefit by joining. We constantly and consistently strive to earn your business. Thank you for allowing us to serve you.

James R. Chadwell, CPA
Secretary/Treasurer

Financial Report

BALANCE SHEET

ASSETS	2013*	2012
Cash & Overnight	\$ 24,899,998	\$ 47,686,053
Investments	291,560,391	292,639,802
Loans to Members	885,537,673	550,349,290
Fixed Assets	24,111,416	19,209,734
Other Assets	17,867,863	18,146,472
TOTAL	\$943,977,341	\$928,031,441
LIABILITIES & EQUITY		
Member Shares	\$ 756,199,849	\$742,359,541
Other Liabilities	10,681,873	9,751,571
Member Equity	177,095,619	175,920,329
TOTAL	\$943,977,341	\$928,031,441

INCOME STATEMENT

	2013*	2012
Interest Income		
Interest on Loans	\$ 34,481,556	\$ 34,958,046
Interest on Investments & Interest Bearing Accounts	3,966,965	2,987,387
Total Interest Income	\$ 38,448,521	\$ 37,945,433
Interest Expense		
Cost of Funds	\$ 3,311,505	\$ 3,999,160
Total Net Interest Income	\$ 35,237,018	\$ 33,946,274
Non-Interest Income	\$ 12,342,804	\$ 12,007,371
Non-Interest Expenses	32,156,406	29,443,439
Provision for Loan Losses	6,079,412	3,280,672
Net Income	\$ 9,344,004	\$ 13,229,534

*Unaudited



COMMONWEALTH
CREDIT UNION

PO Box 978 • Frankfort, KY 40602-0978
800.228.6420 • www.ccuky.org

2013 Annual Report

We CU
DIFFERENTLY


COMMONWEALTH
CREDIT UNION

Annual Meeting Agenda

Roll Call	John C. Scott
Elections	John C. Scott
Board of Directors Report	John C. Scott
Secretary/Treasurer Report	Jim Chadwell
Supervisory Committee Report	Kenneth E. Blackwell Jr.
President's Report	Karen Harbin
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BOARD OF DIRECTORS

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Bill Leach	Director
Randy Overstreet	Director
Alex Rose	Director
Harry Suter	Director

SUPERVISORY COMMITTEE

Kenneth E. Blackwell Jr.	Chairperson
Gary Forman	Vice Chairperson
Kathleen Rodgers	Member
Steve Dooley	Member
Michelle Sutton	Member

Board of Director's Report

This past year has been truly exciting for Commonwealth Credit Union and our members.

We are fortunate to have not one but two reasons for this excitement. We opened new branches in both Georgetown and the Hamburg area of Lexington this past year. Both have been a tremendous asset to our service efforts in those communities.

Both of these branches are significant steps forward for our credit union. Both have many new and unique features that won't be found in most financial institutions. This includes interactive touch-screen displays and a tech area where members can walk through the use of our mobile and online services.

These branches will serve as the model for future branches that we are exploring, starting in the Louisville area.

We also significantly expanded our service to members by adding several ATMs, which are located in Kmart and Walgreens stores in Covington, Florence, Louisville and Somerset.

As you can see, this past year has been one of growth, and we are confident this will continue into the coming year.

On behalf of the entire Board, I want to, once again, thank all our staff for the hard work and dedication they have shown in serving our members/owners this year, and also thank all our members/owners for allowing us the privilege of serving their financial needs.

John C. Scott
Board Chairperson

President's Report

We CU Differently. Sounds so simple, doesn't it? Yet it really does sum up our approach and commitment to member service and what makes us truly stand out when compared to other financial institutions. Throughout the last year, and in the coming one, the products and services we offer illustrate the commitment we have to seeing our members "differently" - more than a number, more than an asset, they are important to us on a personal level. Here are a few highlights from the past year.

1) Mobile Deposit. Members can now deposit checks just by taking a picture of the check through our Mobile App. With today's society being "on the go," this service has become very popular with our members, and will continue to grow and adapt with our members' needs.

2) Everyday Rewards. Our existing credit card Reward program was enhanced to offer "extra" rewards for the items our members purchase most, such as gas and at restaurants.

3) Variable Rate Credit Card. This change to our credit card portfolio allows us to be a leader in the rates we offer our members, particularly by having the ability to offer low rate specials thru the year.

4) Seasonal Loans. These were extremely popular with our members in 2013, as it provided members with a low-rate, fixed term loan. This helped them throughout each season's needs.

5) Sprout Personal Finance Manager. This tool allows our members to track expenses and manage their budgets through our Online Banking service.

6) LEAP Free Savings. This account encourages our members age 13-31 to get into a habit of consistent deposits to their savings account by offering quarterly bonus deposits.

As we continue forward, 2014 promises to be full of the same excitement and challenges that will ensure Commonwealth Credit Union continues to grow and remain one of the top credit unions in the nation.

Karen Harbin, CPA
President/CEO

Supervisory Committee Report

The Supervisory Committee consists of five members appointed by the Board of Directors. The Committee's main duties are to conduct a comprehensive annual audit of the credit union and other audits as necessary. The Committee also performs a financial and management oversight role, independent of the Board of Directors, on behalf of the credit union membership.

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In addition to the annual audit, a team of internal auditors, who report directly to the Committee, has developed a flexible annual audit plan using appropriate risk-based methodology to conduct audits of the credit union. During 2013, the Internal Audit staff completed and issued audit reports in numerous areas. The Internal Auditors' main responsibilities are to assist the Committee in ensuring that internal controls are in place and operating as intended, member assets are being safeguarded, and credit union policies and procedures are followed.

We encourage members and credit union employees to express any concerns to the Committee. The names of those expressing concerns will be held in the strictest confidence by the Committee.

The Committee wishes to thank the Board of Directors and the staff of Commonwealth Credit Union for their assistance and cooperation in 2013.

Kenneth E. Blackwell, Jr., CPA, CIA

Advisory Group Report

Several Advisory Groups met throughout the year to help us enhance our current products and to give insight on future products and services. There were three groups; one each in Frankfort, Georgetown and Lexington.

In addition to these groups, two Gen-Y Advisory Groups met in Frankfort and in Lexington. These groups were comprised of members between the ages of 19-30 and met several times to help us enhance our current products and to give insight on future products and services that would tailor to their specific needs.

Lastly, we had internal associate groups that worked alongside these Advisory Groups and management to provide input on the LEAP Program, as well as confer with us on other products and services to help with their success and make sure they met our members' needs.



We are so excited to finally be in Louisville!
Our St. Matthews Branch is off to a
GREAT START!

Treasurer's Report

A low interest rate market continued throughout 2014 and is expected to extend out to mid-2015. We had strong loan growth and solid share growth that increased our assets by \$35 million, or 3.7%.

We experienced strong earnings compared to the aggregate pool of credit unions in our asset size. These earnings make possible improved delivery systems to our members. In 2014 we rolled out our "Snap It. Pay It." bill payment option and P2P application to enhance the member's online experience. We also opened a new branch in October in Saint Matthews, which is also in a new market - Louisville to better serve members in that area.

Commonwealth loan growth was 9.3% compared to last year. The highest loan growth in dollars was auto participation loans followed by secured member and credit card loans. Loan losses to average loans were up modestly ending at 1.08%. Delinquency ended lower than last year (1.28%) at 0.91%.

Share growth was 3.2% compared to last year. The highest dollar growth was in our High Yield Savings accounts. Members also added checking accounts as we made check deposit more convenient with mobile banking and added online services.

Non-interest income was up 6.58% over last year due primarily to increased interchange fees and sales of insurance products. Non-interest expenses increased 12.77% due to higher employee compensation and pension, supplies and marketing expenses.

We continue to be one of the most solvent credit unions in the U.S. Our capital position is far higher than the average financial institution making us one of the safest places in the nation for members / depositors.

Interest rates for 2015 are expected to rise slightly and regulatory requirements are expected to increase operational expenses. We plan to open additional branches to serve member loan and share needs. Many media financial advisors continue to attest to the positive attributes of credit union membership. We're glad you recognize the tremendous source of financial resources Commonwealth Credit Union provides members. Please encourage your family members to benefit by joining. We constantly and consistently strive to earn your business. Thank you for allowing us to serve you.

James R. Chadwell, CPA
Secretary/Treasurer

Financial Report

BALANCE SHEET

ASSETS	2014*	2013
Cash & Overnight	\$ 21,658,067	\$ 25,591,960
Investments	273,335,680	291,560,391
Net Loans to Members	640,004,345	585,537,673
Fixed Assets	26,407,234	24,111,416
Other Assets	17,799,033	17,175,881
TOTAL	\$979,204,360	\$943,977,341
LIABILITIES & EQUITY		
Member Shares	\$ 780,199,256	\$756,199,849
Other Liabilities	10,561,178	10,681,873
Member Equity	188,443,926	177,095,619
TOTAL	\$979,204,360	\$943,977,341

INCOME STATEMENT

	2014*	2013
Interest Income		
Interest on Loans	\$ 34,806,283	\$ 34,481,556
Interest on Investments & Interest Bearing Accounts	3,641,059	3,006,909
Total Interest Income	\$ 38,447,343	\$ 38,448,521
Interest Expense		
Cost of Funds	\$ 2,882,980	\$ 3,211,501
Interest on Borrowed	102	0
Total Net Interest Income	\$ 35,564,340	\$ 35,237,020
Non-Interest Income	\$ 13,156,195	\$ 12,342,804
Non-Interest Expenses	35,789,977	32,156,408
Provision for Loan Losses	5,176,012	6,079,412
Net Income	\$ 7,954,546	\$ 9,344,004

*Unaudited



COMMONWEALTH
CREDIT UNION

PO Box 978 • Frankfort, KY 40602-0978
800.228.6420 • www.ccu.org

2014 Annual Report



We CU
DIFFERENTLY™


COMMONWEALTH
CREDIT UNION

Annual Meeting Agenda

Roll Call	Alex Rose
Elections	Alex Rose
Board of Directors Report	Alex Rose
Secretary/Treasurer Report	Jim Chadwell
Supervisory Committee Report	Gary Forman
President's Report	Karen Harbin
New Business	Alex Rose
Adjournment	Alex Rose

BOARD OF DIRECTORS

Alex Rose	Chairperson
Bob Bender	Vice Chairperson
Jim Chadwell	Secretary/Treasurer
Karen Harbin	President
Kenny Blackwell	Director
Randy Fawns	Director
Mary Foster	Director
Regina Grubbs	Director
Robin Brewer	Director
Kay Jones	Director
Bill Leach	Director
Randy Overstreet	Director
Harry Suter	Director

SUPERVISORY COMMITTEE

Gary Forman	Chairperson
Michelle Sutton	Vice Chairperson
Kathleen Rodgers	Member
Steve Dooley	Member
Rob Ellis	Member

Board of Director's Report

Your Board of Directors is honored to have had the privilege of serving the members and staff of Commonwealth Credit Union in 2014. The credit union experienced an excellent year, considering that our Commonwealth, as well as our country, were slowly recovering from several years of difficult economic times. Many of our members, especially those who are public employees, continued to struggle with a lack of growth in their incomes. These economic conditions in recent years have made it more difficult for our members to make the major purchases they need for themselves and their families.

The Board and management's challenge has been to maintain our interest rates on loans as low as possible. Our goal is for members to have funds available to them to purchase vehicles, homes, and other items they need. Our efforts brought about outstanding results in 2014, as Commonwealth CU experienced excellent loan growth for the year.

In 2014, we celebrated the opening of two new branches. In October, our long awaited branch in St. Matthews opened with an outstanding staff in place. Members have responded beyond our expectations. The Board wishes to thank all of our members in the Jefferson County area for their patience and loyalty.

We also opened a second branch in Lexington in the Hamburg area because our Meier Way branch had far more member business than it could handle. The Board wishes to thank all of our staff for the dedication and commitment you have shown in serving our members. We also thank all our members for providing us with the opportunity to serve you in meeting your financial needs.

The Board has many interests, duties, and responsibilities in guiding Commonwealth Credit Union. We want our members to know that the responsibility closest to our hearts is that of bettering the lives of our members through Commonwealth CU's financial services. It is not the goal of this Board to be the credit union with the most members or the most assets. Our goal is to be the credit union with the best personal relationships with its members and the credit union that provides the best member service. In other words, our goal is not to be the biggest credit union, only the best one.

Alex Rose
Board Chairperson

President's Report

What a year! The past 12 months have been extremely busy and productive, with growth in so many areas. We challenged our staff all year to go beyond ordinary and see our members "differently," and they certainly succeeded! The excitement and innovation shown by our staff has done so much to allow us to better serve our members and put us in such a great position for the future. Just some of the accomplishments for this year are:

1) New Branches. We began the year putting the final touches on our Hamburg Branch Grand Opening, then ended the year celebrating the Grand Opening of our St. Matthews branch, our first in Louisville.

2) Home Loans. We took this program to an entirely new level of service in 2014! From an educational video series to our First Home Savings Plus program, we helped more members purchase a home than ever before!

3) 0% Credit Cards. This was a huge change in our credit card program, and one that helped our MYCard portfolio become one of our strongest lending programs.

4) #HeyKaren. This one is very personal to me because it allowed me to interact with and impact the lives of members on a personal level. Members sent questions and comments to #HeyKaren, where answers were typically provided within 48 hours. We were able to help people better their lives. The program earned national attention, with multiple credit unions and associations contacting us for more information.

5) Mobile App Enhancements. We launched many new features in 2014, including Snap It. Pay It. and P2P (Person to Person) Payments.

2015 will have a new set of challenges, but I am confident that our Board and Team are more than capable of meeting these challenges. To all our members, I thank you for your trust. We really do CU Differently, and it is our goal for our member service, products and services to make a positive difference in your lives, too.

Karen Harbin, CPA
President/CEO

Supervisory Committee Report

The Supervisory Committee consists of five members appointed by the Board of Directors. The Committee's main duties are to conduct a comprehensive annual audit of the credit union and other audits as necessary. The Committee also performs a financial and management oversight role, independent of the Board of Directors, on behalf of the credit union membership.

The Committee retained the services of Doeren Mayhew CPA's, an independent CPA firm specializing in credit union audits, to conduct the audit as of December 31, 2013. The credit union was given an unqualified or clean opinion for the 2013 financial statements. A copy of this audit report may be reviewed upon request. The firm of Doeren Mayhew CPA's will conduct the audit as of December 31, 2014, which should be available for review in the spring of 2015.

In addition to the annual audit, a team of internal auditors, who report directly to the Committee, has developed a flexible annual audit plan using appropriate risk-based methodology to conduct operational and compliance audits of the credit union. During 2014, the Internal Audit staff completed and issued audit reports in numerous areas. The Internal Auditors' main responsibilities are to assist the Committee in ensuring that internal controls are in place and operating as intended, member assets are being safeguarded, and credit union policies and procedures are followed.

We encourage members and credit union employees to express any concerns to the Committee. The names of those expressing concerns will be held in the strictest confidence by the Committee.

The Committee wishes to thank the Board of Directors and the staff of Commonwealth Credit Union for their assistance and cooperation in 2014.

Gary Forman
Chairman

Orth, Chakler, Murnane and Company, CPAs

A Professional Association

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Web site: www.ocmcpa.com

Douglas J. Orth, CPA, CFE, Managing Partner

Hugh S. Chakler, CPA, CISA, CITP, CFE

John J. Murnane, CPA

James A. Griner, CPA

Lori J. Carmichael, CPA

Daniel C. Moulton, CPA

INDEPENDENT AUDITORS' REPORT

March 5, 2012

To the Supervisory Committee of
Commonwealth Credit Union

We have audited the accompanying statements of financial condition of Commonwealth Credit Union as of December 31, 2011 and 2010, and the related statements of income, comprehensive income, members' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Credit Union's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Credit Union as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Orth, Chakler, Murnane & Co.

Orth, Chakler, Murnane & Company
Certified Public Accountants

OCM&Co

A PROFESSIONAL ASSOCIATION

CPAS

COMMONWEALTH CREDIT UNION STATEMENTS OF FINANCIAL CONDITION
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ASSETS

	As of December 31,	
	2011	2010
Cash and cash equivalents	\$36,710,383	\$20,637,102
Non-negotiable certificates of deposit	11,193,853	39,908,298
Investments:		
Available-for-sale	272,265,514	260,078,852
Held-to-maturity	264,623	1,207,321
Loans to members, net of allowance for loan losses	538,537,221	520,476,803
Accrued interest receivable	2,718,699	3,329,212
Other real estate owned	630,684	968,824
Prepaid and other assets	5,930,766	2,828,320
Property and equipment	19,133,725	21,001,407
NCUSIF deposit	7,216,247	7,377,552
Federal Home Loan Bank stock	1,711,300	1,711,300
Membership capital shares at corporate credit unions	—	691,986
Perpetual contributed capital at corporate credit unions	691,986	—
Total assets	\$897,005,001	\$880,216,977

LIABILITIES AND MEMBERS' EQUITY

	As of December 31,	
	2011	2010
LIABILITIES:		
Members' share and savings accounts	\$725,625,623	\$718,511,847
Accounts payable	4,216,802	3,525,078
Accrued liabilities	4,652,418	4,718,908
Total liabilities	734,494,843	726,755,833
Commitments and contingent liabilities	—	—
MEMBERS' EQUITY:		
Regular reserve	20,827,421	20,827,421
Undivided earnings	140,878,499	131,581,882
Accumulated other comprehensive income	804,238	1,051,841
Total members' equity	162,510,158	153,461,144
Total liabilities and members' equity	\$897,005,001	\$880,216,977

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF INCOME

	For the years ended December 31,	
	2011	2010
INTEREST INCOME:		
Loans to members	\$34,112,363	\$34,026,440
Investments	3,746,197	6,674,048
Total interest income	37,858,560	40,700,488
INTEREST EXPENSE:		
Members' share and savings accounts	6,025,664	10,064,084
Borrowed funds	497	3,625
Total interest expense	6,026,161	10,067,709
Net interest income	31,832,399	30,632,779
PROVISION FOR LOAN LOSSES	3,684,692	3,404,052
Net interest income after provision for loan losses	28,147,707	27,228,727
NON-INTEREST INCOME:		
Fees and service charges	11,921,055	10,680,072
	40,068,762	37,908,799
NON-INTEREST EXPENSE:		
Compensation and employee benefits	18,603,136	18,503,711
Office operating and occupancy	9,062,362	8,844,211
NCUA insurance premium assessments	1,766,562	1,870,886
Miscellaneous operating	1,340,085	1,393,486
Impairment of membership capital shares at corporate credit unions	—	110,974
Total non-interest expense	30,772,145	30,723,268
Net income	\$9,296,617	\$7,185,531

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF COMPREHENSIVE INCOME

	For the years ended December 31,	
	2011	2010
NET INCOME	\$9,296,617	\$7,185,531
OTHER COMPREHENSIVE LOSS:		
Unrealized holding losses arising during the year on investments classified as available-for-sale	(247,603)	(73,537)
Reclassification adjustments for (gains)/losses included in net income	—	—
Other comprehensive loss	(247,603)	(73,537)
Comprehensive income	\$9,049,014	\$7,111,994

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF MEMBERS' EQUITY
--

For the years ended December 31, 2011 and 2010				
	Regular Reserve	Undivided Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
Balance, December 31, 2009	\$20,827,421	\$124,396,351	\$1,125,378	\$146,349,150
Net income	—	7,185,531	—	7,185,531
Other comprehensive loss	—	—	(73,537)	(73,537)
Balance, December 31, 2010	20,827,421	131,581,882	1,051,841	153,461,144
Net income	—	9,296,617	—	9,296,617
Other comprehensive loss	—	—	(247,603)	(247,603)
Balance, December 31, 2011	\$20,827,421	\$140,878,499	\$804,238	\$162,510,158

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$9,296,617	\$7,185,531
Adjustments:		
Provision for loan losses	3,684,692	3,404,052
Depreciation	1,740,299	2,152,674
Amortization of deferred loan origination fees/costs	569,326	496,175
(Gain)/loss on sale of other real estate owned	(29,655)	21,555
Amortization/accretion of investment premiums/discounts, net	2,608,683	2,377,723
Impairment of membership capital shares at corporate credit unions	—	110,974
Gain on sale of fixed assets	(22,592)	—
Changes in operating assets and liabilities:		
Accrued income receivable	610,513	690,704
Prepaid and other assets	(3,102,446)	1,818,585
Accounts payable and accrued liabilities	625,234	473,089
Net cash provided by operating activities	15,980,671	18,731,062
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and repayments of available-for-sale securities	338,381,988	143,998,560
Purchase of available-for-sale securities	(353,421,629)	(185,407,019)
Proceeds from maturities and repayments of held-to-maturity securities	939,391	1,565,372
Change in NCUSIF deposit	161,305	33,930
Net change in loans, net of charge-offs	(23,275,376)	(21,853,783)
Recoveries on loans charged off	663,663	658,987
Net change in non-negotiable certificates of deposit	28,714,445	60,660,901
Expenditures for property and equipment	(267,585)	(1,492,925)
Proceeds from sale of other real estate owned	665,072	641,203
Proceeds from sale of fixed assets	417,560	—
Net cash used in investing activities	(7,021,166)	(1,194,774)

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF CASH FLOWS

Cash Flows: (continued)

	For the years ended December 31,	
	2011	2010
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in members' share and savings accounts	7,113,776	(8,619,411)
Net cash provided by/(used in) financing activities	7,113,776	(8,619,411)
Net change in cash and cash equivalents	16,073,281	8,916,877
Cash and cash equivalents at beginning of year	20,637,102	11,720,225
Cash and cash equivalents at end of year	\$36,710,383	\$20,637,102
SUPPLEMENTAL CASH FLOWS DISCLOSURES:		
Interest paid	\$6,026,161	\$10,067,709
SCHEDULE OF NON-CASH TRANSACTIONS:		
Transfers from loans to members to other real estate owned	\$297,277	\$661,029
Transfers from membership capital shares at corporate credit unions to perpetual contributed capital at corporate credit unions	\$691,986	\$—
Other comprehensive loss	(\$247,603)	(\$73,537)

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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***NOTE 1: SIGNIFICANT
ACCOUNTING POLICIES***

ORGANIZATION

Commonwealth Credit Union (the Credit Union) is a cooperative association organized in accordance with Chapter 290 of the Kentucky State Chartered Credit Union Law. Participation in the Credit Union is limited to those individuals that qualify for membership. The field of membership is defined in the Credit Union's Charter and Bylaws.

FINANCIAL STATEMENTS/USE OF ESTIMATES

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP/USA) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the periods then ended. Estimates that are particularly susceptible to change relate to the determination of the allowance for loan losses and the fair value of financial instruments. The significant accounting principles and policies used in the preparation of these financial statements, together with certain related information, are summarized below.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents includes amounts due from banks and credit unions and cash on hand. Amounts due from banks and credit unions may, at times, exceed federally insured limits.

INVESTMENTS

Investments are classified into the following categories: held-to-maturity and available-for-sale. Investment securities classified as held-to-maturity are measured at amortized cost. This classification is based upon the Credit Union's intent and ability to hold these investment securities to full maturity. Investment securities classified as available-for-sale are measured at fair value as of the statement of financial condition date. Unrealized gains and losses for available-for-sale investments are reported as a separate component of members' equity. Investments are adjusted for amortization of premiums and accretion of discounts over the term of the investment by a method which approximates the interest method. Adjustments are recognized to interest income on investments. Realized gains and losses on disposition, if any, are computed using the specific identification method.

MEMBERSHIP CAPITAL SHARES/PERPETUAL CONTRIBUTED CAPITAL AT CORPORATE CREDIT UNIONS

Membership capital shares can only be withdrawn after providing three-years notice. During 2011, KyCorp converted the existing membership capital shares to perpetual contributed capital to meet the requirements of the newly revised NCUA Regulations. As a result, the Credit Union agreed to the conversion of its existing membership capital shares to perpetual contributed capital. Perpetual contributed capital is not insured, has no maturity, and would not be returned to the Credit Union upon request without the approval of the NCUA. Perpetual contributed capital could be sold to another credit union if the Credit Union could find a willing buyer.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS

Note 1: (continued)

FEDERAL HOME LOAN BANK (FHLB) STOCK

As a member of the FHLB, the Credit Union is required to make a minimum stock investment with the FHLB based on a formula developed by the FHLB that considers the Credit Union's total assets and outstanding advances from the FHLB. No ready market exist for the FHLB stock and it has no quoted market price.

LOANS TO MEMBERS AND ALLOWANCE FOR LOAN LOSSES

Loans to members are stated at the amount of unpaid principal, net of an allowance for loan losses (ALL) and deferred loan origination fees and costs. The ALL is increased by a provision for loan losses charged to expense and decreased by charge-offs (net of recoveries). The ALL is maintained at an amount that represents management's estimate of losses that may be sustained in the liquidation of currently outstanding loans. Management's periodic evaluation of the adequacy of the ALL account is based on the Credit Union's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and current economic conditions that may affect the borrower's ability to repay.

Interest on loans is recognized over the terms of the loans and is calculated on principal amounts outstanding. The accrual of interest is discontinued when a loan exceeds 90 days delinquent or when management believes that collection of interest is doubtful. Loan fees which are charged to members and direct origination costs on indirect vehicle loans are deferred and amortized as an adjustment of loan yield over the estimated life of the loan using a method that approximates the interest method. Direct loan origination costs on consumer loans are recognized in expenses when incurred. This is not materially different from expenses that would have been recognized under the provisions of the Nonrefundable Fees and Other Costs Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC).

ALL METHODOLOGY

Management has an established methodology to determine the adequacy of the ALL that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the ALL, the Credit Union has segmented certain loans in the portfolio by product type. Loans are segmented into the following pools: commercial, real estate, and consumer. The Credit Union also sub-segments these segments into classes based on the associated risks within those segments. Commercial loans are Business Partners (BP), Inc, participation loans secured by commercial real estate. Member owned real estate loans are divided into the following classes: First and Second Mortgages and Home Equity Loans. Consumer loans are divided into the following classes: Vehicle, Unsecured, and Other Secured.

Each class of loans requires significant judgment to determine the estimation method that fits the credit risk characteristics of its portfolio segment. The Credit Union uses both internally developed and vendor supplied models in the process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the allowance are independently validated and reviewed to ensure the theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 1: (continued)

The following describes how management determines the balance of the allowance for loan losses for each segment or class of loans.

CONSUMER PORTFOLIO SEGMENT ALL METHODOLOGY

For consumer loans, the Credit Union determines the ALL on a collective basis utilizing historical loss ratios to represent the best estimate of incurred losses at the measurement date. Loans are pooled generally by loan types with similar risk characteristics. As of December 31, 2011, the historical ratios were developed from the following historical data:

Direct New Auto - Rolling 36 Months
 Direct Used Auto - Rolling 36 Months
 New Indirect Auto - Rolling 36 Months
 Used Indirect Auto - Rolling 36 Months
 Unsecured Personal Loans - Rolling 36 Months
 Unsecured Credit Cards - Rolling 36 Months
 Other Secured Loans - Rolling 36 Months

As appropriate, to achieve greater accuracy, further stratification of a selected portfolio may occur such as by year of origination, geographic location and other predictive characteristics. The consumer ALL model primarily uses historic delinquency and default experience. The consumer ALL may include an estimate for the losses on individually evaluated impaired consumer loans.

REAL ESTATE PORTFOLIO SEGMENT ALL METHODOLOGY

For real estate loans, the Credit Union determines the ALL on a collective basis utilizing historical loan loss ratios to represent the best estimate of incurred losses at the measurement date. Loans are pooled by loan types with similar risk characteristics. As of December 31, 2011, the historical loss time frame for each class was as follows:

First and Second Mortgage - Rolling 36 Months
 Home Equity Line of Credit - Rolling 36 Months

As appropriate, to achieve greater accuracy, further stratification of a selected portfolio may occur such as by year of origination, geographic location and other predictive characteristics. The real estate ALL model primarily uses historic delinquency and default experience. The real estate ALL may include an estimate for the losses on individually evaluated impaired real estate loans.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 1: (continued)

COMMERCIAL PORTFOLIO SEGMENT ALL METHODOLOGY

Commercial loans are individually reviewed for potential losses. Based on credit risk assessments and management's analysis of leading predictors of losses, a loss multiplier is applied to individual loan balances. These loss estimates are adjusted as appropriate based on predetermined ranges based on BP annual review ratings, analysis of long-term average loss experience compared to previously forecasted losses, external loss data or other risks identified from current economic conditions and credit quality trends. As of December 31, 2011, the commercial loans are pooled as real estate and construction.

LOAN CHARGE-OFF POLICIES

The Credit Union's quality control process includes preparing lists to monitor and track delinquent loans. Tracking the loans on these lists enables management to assess the performance of the loan portfolio and act to mitigate risk therein through necessary changes in policy and procedures. The quality control process also serves as a tool to assist the Credit Union in identifying loans for charge off on a timely basis.

The following is a description of the Credit Union's loan charge-off policies:

Consumer, real estate and commercial loans are generally charged off when:

- The loan has been determined to be uncollectible by the Collection Manager regardless of the number of months delinquent.
- Repayment is deemed to be protracted beyond reasonable time frames.
- The loan is a deficiency balance from the sale of collateral and the borrower has indicated an unwillingness to make further payments, and there are no other tangible assets.
- Loans included in Chapter 7 Bankruptcy when the member is not reaffirming and the Bankruptcy Judge will grant discharge of the debt.
- Unsecured loans included in Chapter 13 Bankruptcy and the Bankruptcy Trustee has confirmed the Plan. Secured loans with balances in excess of the value of the collateral held at the time of the final confirmation will be "written down" in a partial charge-off to the actual value of the collateral.
- The remaining balance on a delinquent loan, when the Credit Union agrees to "settle" the loan for an amount less than the outstanding balance.
- The borrower is determined to be a "skip" and the Credit Union has been unable to establish any contact with the borrower for 180 days.
- Fraud has been committed and there is no realistic chance of recovery.

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**
Note 1: (continued)

- The loan is 180 days or more delinquent, unless one or more of the following conditions exist:
 - ▶ The loan is well secured.
 - ▶ The Credit Union or the member is waiting on a settlement of a documented insurance/bond claim that will be paid in a reasonable period of time.
 - ▶ The member is deceased and the Credit Union has substantial reason to expect settlement from the estate, co-borrower or relatives in a reasonable period of time.
 - ▶ The Credit Union is waiting on proceeds related to the sale of repossessed collateral, a refund of collateral protection insurance is expected, extended warranty refund is expected or any other repossession related refunds are anticipated.
 - ▶ The Credit Union has pending litigation concerning the loan and expects to receive a favorable judgment and avenue of collection.
 - ▶ The Credit Union has made arrangements or has a reasonable expectation that the recovery of the delinquent funds will be made.

OTHER REAL ESTATE OWNED

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell.

PROPERTY AND EQUIPMENT

Land is carried at cost. Property and equipment are carried at cost less accumulated depreciation. Buildings, and furniture and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. The Credit Union reviews property and equipment (long-lived assets) for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

NCUSIF DEPOSIT

The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with National Credit Union Administration (NCUA) regulations, which require the maintenance of a deposit by each federally insured credit union in an amount equal to 1% of its insured members' shares. The deposit would be refunded to the Credit Union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board.

<p style="text-align: center;">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
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Note 1: (continued)

NCUA INSURANCE PREMIUM ASSESSMENTS

During 2010, the NCUA Board assessed a 13.4 basis point insurance premium on insured deposits as of March 31, 2010 and a 12.42 basis point insurance premium on insured deposits as of June 30, 2010. During 2011, the NCUA Board assessed a 25 basis point insurance premium on insured deposits as of June 30, 2011.

MEMBERS' SHARE AND SAVINGS ACCOUNTS

Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Interest on members' share and savings accounts is based on available earnings at the end of an interest period and is not guaranteed by the Credit Union. Interest rates on members' share accounts are ratified by the Board of Directors, based on an evaluation of current and future market conditions.

MEMBERS' EQUITY

The Credit Union is required to maintain a statutory reserve (regular reserve) in accordance with the Federal Credit Union Act. This statutory reserve represents a regulatory restriction and is not available for the payment of interest.

FEDERAL AND STATE TAX EXEMPTION

The Credit Union is exempt from most federal, state, and local taxes under the provisions of the Internal Revenue Code and state tax laws. FASB ASC 740-10-25, which clarifies accounting for uncertainty in income taxes reported in the financial statements. The interpretation provides criteria for assessment of individual tax positions and a process for recognition and measurement of uncertain tax positions. Tax positions are evaluated on whether they meet the "more likely than not" standard for sustainability upon examination by tax authorities. The Credit Union is a state-chartered credit union as defined in Internal Revenue Code (IRC) Section 501(c)(14). As such, the Credit Union is exempt from federal taxation of income derived from the performance of activities directly related to its exempt purposes. However, IRC Section 511 imposes a tax on the unrelated business income (UBI) derived by state-chartered credit unions.

Beginning in March 2008, the Internal Revenue Service (IRS) released Technical Advice Memorandums (TAMs) to specific state-chartered credit unions specifying the revenue sources subject to unrelated business income tax (UBIT). UBI may also be subject to tax in certain states. As a result of adopting ASC 740-10-25, the Credit Union has assessed its activities and any potential federal or state income tax liability and determined that the Credit Union has no uncertain tax positions that qualify for either recognition or disclosure in the financial statements. Additionally, no interest and penalties have been recorded in the accompanying financial statements related to uncertain tax positions. Currently, the 2010, 2009, and 2008 federal income tax returns are open for examination by the IRS. The filing years open for examination by the state, if applicable, may be equal to, greater than or less than the years open for examination by the IRS.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 1: (continued)**SUBSEQUENT EVENTS**

Management has evaluated subsequent events through March 5, 2012, the date the financial statements were available to be issued. Management has not identified any items requiring recognition or disclosure.

NEW ACCOUNTING PRONOUNCEMENTS

There is a proposal by the Governmental Accounting Standards Board (GASB) to amend Statement No. 27 as it relates to Accounting and Financial Reporting for Pensions by governmental entities. The Credit Union's employees participate in a government sponsored pension plan. This proposal would require the governmental entity to recognize the actuarial projected benefit obligation due to employees under a state sponsored defined benefit pension plan. Currently, the pension plan only requires the Credit Union to reimburse the plan for the current obligations due to employees enrolled in the plan. However, if enacted, the proposal will require the Credit Union to record a liability due to the pension plan for their portion of the actuarial projected benefit obligation. This accrual would have a significant impact on the Credit Union's financial statements. This proposed amendment would be effective for periods beginning after June 15, 2013.

NOTE 2: INVESTMENTS

The amortized cost and estimated fair value of investments are as follows:

As of December 31, 2011				
<u>Available-for-sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agency securities	\$201,466,939	\$170,921	(\$10,745)	\$201,627,115
Mortgage-backed securities	69,994,337	916,809	(272,747)	70,638,399
	<u>\$271,461,276</u>	<u>\$1,087,730</u>	<u>(\$283,492)</u>	<u>\$272,265,514</u>
As of December 31, 2010				
<u>Available-for-sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agency securities	\$182,023,361	\$459,501	(\$268,393)	\$182,214,469
Mortgage-backed securities	77,003,650	1,059,428	(198,695)	77,864,383
	<u>\$259,027,011</u>	<u>\$1,518,929</u>	<u>(\$467,088)</u>	<u>\$260,078,852</u>

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 2: (continued)

		As of December 31, 2011			
<u>Held-to-maturity:</u>		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage-backed securities		\$264,623	\$—	(\$32,468)	\$232,155

		As of December 31, 2010			
<u>Held-to-maturity:</u>		Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage-backed securities		\$1,207,321	\$—	(\$10,338)	\$1,196,983

The amortized cost and estimated fair value of investments by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay certain obligations without call or prepayment penalties.

		As of December 31, 2011			
		<u>Available-for-sale</u>		<u>Held-to-maturity</u>	
		Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within 1 year		\$101,309,332	\$101,332,192	\$—	\$—
1 to 5 years		100,157,607	100,294,923	—	—
		201,466,939	201,627,115	—	—
Mortgage-backed securities		69,994,337	70,638,399	264,623	232,155
		\$271,461,276	\$272,265,514	\$264,623	\$232,155

The following tables show the gross unrealized losses and fair value of investments, aggregated by length of time that individual securities have been in a continuous unrealized loss position.

		As of December 31, 2011					
		<u>Available-for-sale</u>					
		<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
		Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Federal agency securities		\$26,266,385	(\$10,745)	\$—	\$—	\$26,266,385	(\$10,745)
Mortgage-backed securities		23,272,357	(221,722)	3,818,554	(51,025)	27,090,911	(272,747)
		\$49,538,742	(\$232,467)	\$3,818,554	(\$51,025)	\$53,357,296	(\$283,492)

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 2: (continued)

As of December 31, 2010						
<i>Available-for-sale</i>						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
Federal agency securities	\$99,085,273	(\$268,393)	\$—	\$—	\$99,085,273	(\$268,393)
Mortgage-backed securities	12,075,972	(129,702)	8,428,588	(68,993)	20,504,560	(198,695)
	\$111,161,245	(\$398,095)	\$8,428,588	(\$68,993)	\$119,589,833	(\$467,088)

As of December 31, 2011						
<i>Held-to-maturity</i>						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
Mortgage-backed securities	\$—	\$—	\$232,155	(\$32,468)	\$232,155	(\$32,468)

As of December 31, 2010						
<i>Held-to-maturity</i>						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
Mortgage-backed securities	\$1,196,983	(\$10,338)	\$—	\$—	\$1,196,983	(\$10,338)

Unrealized losses on securities issued by the U.S. Government and its agencies have not been recognized into income because the principal balances of these securities are guaranteed by the U.S. Government. Additionally, the decline in the fair values of the investment securities is largely due differences between security yields and market interest rates and the fair values of the securities are expected to be recovered as these securities approach their maturity date and/or market rates decline. Management has the ability to hold these securities until recovery, which may be maturity.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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NOTE 3: LOANS TO MEMBERS

The composition of loans to members is as follows:

	As of December 31,	
	2011	2010
Consumer:		
Direct new auto	\$12,053,872	\$13,766,419
Direct used auto	66,644,856	65,570,244
Indirect new auto	26,732,658	27,706,774
Indirect used auto	56,982,450	48,387,546
Unsecured personal loans	48,211,487	43,137,974
Unsecured credit card loans	64,222,352	58,986,962
Other secured	7,473,525	7,704,484
Total consumer	<u>282,321,200</u>	<u>265,260,403</u>
Real estate:		
First and second mortgage	196,719,851	193,696,612
Home equity line of credit (HELOC)	47,062,285	46,062,560
Total real estate	<u>243,782,136</u>	<u>239,759,172</u>
Commercial:		
Real estate	17,404,371	20,049,610
Total commercial	<u>17,404,371</u>	<u>20,049,610</u>
Total loans	543,507,707	525,069,185
Net deferred loan origination fees/costs	702,338	614,502
	<u>544,210,045</u>	<u>525,683,687</u>
Less allowance for loan losses	(5,672,824)	(5,206,884)
	<u><u>\$538,537,221</u></u>	<u><u>\$520,476,803</u></u>

A summary of the activity in the allowance for loan losses is as follows:

	For the year ended December 31, 2011			
	Consumer	Real Estate	Commercial	Total
Balance, beginning of year	\$4,813,748	\$48,283	\$344,853	\$5,206,884
Provision for loan losses	2,094,271	145,732	1,444,689	3,684,692
Recoveries	660,211	3,452	—	663,663
Loans charged off	(3,091,733)	(100,150)	(690,532)	(3,882,415)
Balance, end of year	<u>\$4,476,497</u>	<u>\$97,317</u>	<u>\$1,099,010</u>	<u>\$5,672,824</u>
Ending balance:				
Individually evaluated for impairment	\$—	\$—	\$613,218	\$613,218
Collectively evaluated for impairment	<u>\$4,476,497</u>	<u>\$97,317</u>	<u>\$485,792</u>	<u>\$5,059,606</u>

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 3: (continued)

A summary of the recorded investment in loans by portfolio segment is as follows:

	As of December 31, 2011			
	Consumer	Real estate	Commercial	Total
Ending balance	\$283,023,537	\$243,782,137	\$17,404,371	\$544,210,045
Individually evaluated for impairment	\$262,860	\$368,986	\$3,488,243	\$4,120,089
Collectively evaluated for impairment	\$282,760,677	\$243,413,151	\$13,916,128	\$540,089,956

A summary of the activity in the allowance for loan losses for the year ended December 31, 2010, is as follows:

	For the year ended December 31, 2010
Balance, beginning of year	\$6,070,451
Provision for loan losses	3,404,052
Recoveries	658,987
Loans charged off	(4,722,242)
Loan participation charge off correction	(204,364)
Balance, end of year	\$5,206,884

IMPAIRED LOANS

A loan is impaired when it is probable, based on current information and events, the credit union will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement.

The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable. Management determined the specific allowance based on but not limited to the payment history, legal status, risk rating, reduction in rental payments or occupancy rates supporting the loan, failure to pay taxes or provide key financial information requested as an on-going condition of the loan and other information as applicable. In those cases, the current fair value of the collateral, less selling costs was used to determine the specific allowance recorded.

Also presented are the average recorded investment in the impaired loans and the related amount of interest recognized during the time within the period that the impaired loans were impaired. Interest is credited to interest income when received, under the cash basis method, unless the loan is less than 90 days delinquent when the accrual method is used and interest income is accrued on the loan. The average balances are calculated based on the month-end balances of the loans of the period reported.

Payments received on impaired loans are recorded as a reduction of principal or as interest income depending on its delinquency status. Generally, interest income on an impaired loan is recorded on a cash basis when the outstanding principal is brought current. Interest income recorded on impaired loans for all periods presented was recorded on a cash basis.

COMMONWEALTH CREDIT UNION

NOTES TO THE FINANCIAL STATEMENTS

Note 3: (continued)

The table below summarizes key information for impaired loans:

	As of December 31, 2011			For the Year Ended December 31, 2011	
	Recorded Investment	Unpaid Principal Balance	Specific Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Consumer:					
Direct auto loans	\$139,344	\$138,344	\$—	\$146,318	\$7,837
Indirect auto loans	125,066	124,516	—	140,647	5,271
Real estate:					
First/Second mortgage	338,852	338,852	—	361,510	17,420
HELOC	30,134	30,134	—	31,554	1,935
Commercial:					
Real estate	354,208	354,047	—	467,955	17,797
With an allowance recorded:					
Commercial:					
Real estate	3,377,150	3,134,194	613,218	3,599,640	166,074
Totals:					
Consumer	\$264,410	\$262,860	\$—	\$286,965	\$13,108
Real estate	368,986	368,986	—	393,064	19,355
Commercial	3,731,358	3,488,241	613,218	4,067,595	183,871
	<u>\$4,364,754</u>	<u>\$4,120,087</u>	<u>\$613,218</u>	<u>\$4,747,624</u>	<u>\$216,334</u>

The table below provides an age analysis of past due loans by class:

	As of December 31, 2011						
	Days Delinquent				Total Delinquent Loans	Total Current Loans	Total Loans
	30-60	61-90	91-180	Over 180			
Consumer:							
Direct Auto	\$572,011	\$218,649	\$380,068	\$331,616	\$1,502,344	\$77,196,384	\$78,698,728
Indirect Auto	907,058	204,429	216,379	183,182	1,511,048	82,906,398	84,417,446
Unsecured Personal	305,338	174,653	171,026	22,102	673,119	47,538,368	48,211,487
Unsecured Credit Card	347,205	172,694	205,560	12,190	737,649	63,484,703	64,222,352
Modified Loans	72,745	73,464	53,684	1,541	201,434	—	—
Other secured	17,532	4,682	14,323	24,074	60,611	7,412,914	7,473,525
Real estate:							
First/Second mortgage	267,283	77,944	145,269	687,932	1,178,428	195,541,423	196,719,851
HELOC	119,645	28,704	98,077	98,830	345,256	46,717,029	47,062,285
Commercial:							
Real estate	—	—	696,163	455,741	1,151,904	16,252,467	17,404,371
Total	<u>\$2,608,817</u>	<u>\$955,219</u>	<u>\$1,980,549</u>	<u>\$1,817,208</u>	<u>\$7,361,793</u>	<u>\$537,049,686</u>	<u>\$544,210,045</u>

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 3: (continued)

The Credit Union places loans on non-accrual status when the full and timely collection of interest or principal becomes uncertain, part of the principal balance has been charged-off and no restructuring has occurred or the loans reach 90 days past due. Loans on which the accrual of interest has been discontinued or reduced approximated \$3,798,000 and \$6,892,000 as of December 31, 2011 and 2010, respectively. There were no loans 90 days or more past due and still accruing interest as of December 31, 2011 or 2010.

TROUBLED DEBT RESTRUCTURING/MODIFICATIONS

The Credit Union's loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (TDR), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Credit Union's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. TDRs are classified as non-accrual at the time of restructure and are returned to accrual status after receiving on time payments for six consecutive months.

When the Credit Union modifies a loan, management evaluates impairment based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan agreement. However, in certain cases, management uses the current fair value of the collateral, less selling costs. The loan is further analyzed for consideration of the risk of re-default. If management determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs and deferred loan fees or costs), impairment is recognized by segment or class of loan, as applicable, through the ALL estimate. Segment and class status is determined by the loan's classification at origination.

The following table includes the recorded investment and number of modifications for modified loans. The Credit Union reports the recorded investment in the loans prior to a modification and also the recorded investment in loans after the loans were restructured. Management has also disclosed the recorded investment and number of modifications for TDRs within the last year where a concession has been made as well as the amount and number of TDRs that have defaulted in the current reporting period. Management defines a TDR as subsequently defaulted when it is charged-off.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 3: (continued)

The following table presents the TDRs performed or charged off by class of loans during the year ended December 31, 2011:

	For the year ended December 31, 2011	
	TDRs approved during the period	TDRs which subsequently defaulted
Real estate:		
First and second mortgage	\$176,051	\$47,972
HELOC	1,407	—
Commercial:		
Real estate	463,615	521,287
Total	\$641,073	\$569,259

COMMERCIAL CREDIT QUALITY INDICATORS

The following table represents commercial credit exposures by creditworthiness category as of December 31, 2011. The use of creditworthiness categories to grade loans permits management's use of migration analysis to estimate a portion of credit risk. The Credit Union's internal creditworthiness grading system is based on experiences with similarly graded loans. Category ratings are reviewed at least each quarter, at which time management analyzes the resulting scores, as well as other external statistics and factors, to track the migration of loan performance. Loans that trend upward toward higher quality levels generally have a lower risk factor associated. Whereas, loans that migrate toward a lower credit rating generally will result in a higher risk factor being applied to those related loan balances.

The internal risk ratings for Business Partner, Inc., participation loans are as follows:

Commercial Credit Quality Indicators
As of December 31, 2011
Commercial Credit Exposure

	Total
1 - Excellent	\$—
2 - Strong	232,861
3 - Satisfactory	6,110,118
4 - Watch list	3,664,567
5 - Special mention	4,301,593
6 - Substandard	1,883,541
7 - Loss	1,211,691
	\$17,404,371

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**

Note 3: (continued)

CONSUMER AND REAL ESTATE CREDIT QUALITY INDICATORS

The Credit Union categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation and current economic trends among other factors. This analysis is performed monthly. The Credit Union uses the following definitions for risk ratings:

- **Special Mention.** Loans are classified as special mention when it is determined a loan relationship should be monitored more closely. Loans that are 60 days to 89 days past due are classified as special mention.
- **Substandard.** Loans that are 90 to 365 days past due are classified as substandard. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected.
- **Doubtful.** Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable. These loans are greater than 365 days past due.

Loans not meeting the criteria as part of the above described process are considered to be pass rated loans. Pass rated loans are generally well protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. Pass rated assets are not more than 59 days past due but are generally performing in accordance with the loan terms.

The table below summarizes key information for real estate credit quality:

**Real Estate Credit Quality Indicators
As of December 31, 2011
Real Estate Credit Exposure**

	Pass	Special Mention	Substandard	Doubtful	Total
First/Second Mortgage	\$195,808,705	\$223,213	\$535,771	\$152,162	\$196,719,851
HELOC	46,836,674	126,781	49,685	49,145	47,062,285
	<u>\$242,645,379</u>	<u>\$349,994</u>	<u>\$585,456</u>	<u>\$201,307</u>	<u>\$243,782,136</u>

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 3: (continued)

METHODOLOGY CHANGES

Prior to August 2009, the Credit Union used a historical loss period of 36 months to develop loan loss ratios for all segments to estimate the allowance for loan losses on the pools of loans. However, due to the financial crisis facing the country in August 2009, the Credit Union implemented changes to its ALL methodology to use a 12-month time frame for all loan segments. An industry loss ratio was used for BP participation commercial real estate loans. In 2011, management changed the BP participation commercial real estate loan classification to an individual review for estimated losses contained in this segment. In addition, management changed the historical loss periods used to estimate incurred losses on member owned real estate and consumer loans to 36 months to better reflect the risk related to these loans based on actual charge-offs during the year and greater transparency gained in reviewing the loan losses, allowance outstanding, provision contribution and recoveries by loan segment during 2011.

The following table represents the effects of changes to methodology from the prior period on the current period provision.

	Calculated Provision based on Prior Year Methodology	Calculated Provision based on Current Year Methodology	Difference
Portfolio Segment:			
Consumer	\$3,323,652	\$3,867,763	\$544,111
Real estate	106,834	97,317	(9,517)
Commercial	299,355	1,099,010	799,655
Total	<u>\$3,729,841</u>	<u>\$5,064,090</u>	<u>\$1,334,249</u>

NOTE 4: PROPERTY AND EQUIPMENT

A summary of the Credit Union's property and equipment is as follows:

	As of December 31,	
	2011	2010
Land	\$3,468,245	\$3,863,130
Buildings	23,738,378	23,703,139
Furniture and equipment	11,323,298	13,358,342
	38,529,921	40,924,611
Less accumulated depreciation	(19,396,196)	(19,923,204)
	<u>\$19,133,725</u>	<u>\$21,001,407</u>

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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***NOTE 5: MEMBERS' SHARE
AND SAVINGS ACCOUNTS***

Members' share and savings accounts are summarized as follows:

	As of December 31,	
	2011	2010
Share draft accounts	\$83,490,031	\$72,992,674
Share accounts	302,269,785	280,857,663
Money market accounts	98,468,577	99,114,456
Individual retirement accounts	22,140,503	20,492,274
Certificates of deposit and IRA certificates	219,256,727	245,054,780
	<u>\$725,625,623</u>	<u>\$718,511,847</u>

The aggregate amount of members' time deposit accounts in denominations of \$100,000 and over was approximately \$53,683,000 and \$57,534,000 as of December 31, 2011 and 2010, respectively.

Scheduled maturities of share and IRA certificates are as follows:

	As of December 31, 2011
Within 1 year	\$137,716,600
1 to 2 years	43,046,095
2 to 3 years	14,793,357
3 to 4 years	14,621,378
4 to 5 years	7,960,568
Thereafter	1,118,729
	<u>\$219,256,727</u>

SHARE INSURANCE

Members' share accounts are insured by the NCUSIF to a maximum of \$250,000 for each member. Individual Retirement Accounts are separately insured to a maximum of \$250,000. The Credit Union also maintains excess share insurance through Excess Share Insurance Corporation which provides an additional amount of share insurance of \$100,000 per account.

NOTE 6: EMPLOYEE BENEFITS

PENSION PLAN

The Credit Union participates in a state sponsored defined benefit pension plan covering substantially all of its employees. For the years ended December 31, 2011 and 2010, contributions and cost were determined as a percentage of each covered employee's paid earnings and totaled approximately \$2,280,000 and \$1,790,000 for the years ended December 31, 2011 and 2010, respectively.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
***NOTE 7: COMMITMENTS AND
CONTINGENT LIABILITIES***
LEASE COMMITMENTS

The Credit Union had outstanding commitments under operating leases for ATM equipment and servicing as of December 31, 2011. The minimum noncancellable lease obligations approximate the following as of December 31, 2011:

Year ending December 31,	Amount
2012	\$308,000
2013	144,000
2014	62,000
2015	19,000
2016	5,000
Thereafter	4,000
	\$542,000

Rental expense under operating leases was approximately \$308,000 and \$305,000 for the years ended December 31, 2011 and 2010, respectively.

LINES OF CREDIT

As of December 31, 2011, the Credit Union maintained an unused line of credit with KyCorp. The KyCorp agreement requires the pledging of all assets as security for obligations under this line-of-credit agreement. The aggregate unused line of credit under this agreement was \$10,000,000 as of December 31, 2011.

As a member of the FHLB, the Credit Union had access to a pre-approved secured line of credit with the capacity to borrow up to a certain percentage of the value of its eligible 1-4 family first mortgage loans, as defined in the FHLB Statement of Credit Policy. The aggregate unused line of credit under this agreement was approximately \$44,835,000 as of December 31, 2011.

***NOTE 8: OFF-BALANCE-SHEET RISK
AND CONCENTRATIONS OF CREDIT RISK***
OFF-BALANCE SHEET RISK:

The Credit Union is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statements of financial condition. Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 8: (continued)

Since many of the commitments may expire without being fully drawn upon, the total commitment amounts do not necessarily represent future cash requirements. As of December 31, 2011, the total unfunded commitment under such lines of credit was approximately \$223,323,000. The Credit Union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the member.

CONCENTRATIONS OF CREDIT RISK

The Credit Union may be exposed to credit risk from a regional economic standpoint, since a significant concentration of its borrowers work or reside in the state of Kentucky. However, the loan portfolio is well diversified and the Credit Union does not have any significant concentrations of credit risk.

NOTE 9: REGULATORY CAPITAL

The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth (as defined in NCUA Regulations) to total assets (as defined in NCUA Regulations). Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNWR as of December 31, 2011 and 2010 was 5.05% and 4.84% respectively. The minimum ratio to be considered complex under the regulatory framework is 6.00%. Management believes, as of December 31, 2011 and 2010, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2011, the most recent call reporting period, the NCUA categorized the Credit Union as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized" the Credit Union must maintain a minimum net worth ratio of 7.00% of total assets. There are no conditions or events since that notification that management believes have changed the Credit Union's category.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 9: (continued)

The Credit Union's actual and required net worth amounts and ratios are as follows:

	As of December 31, 2011		As of December 31, 2010	
	Amount	Ratio/ Requirement	Amount	Ratio/ Requirement
Actual net worth	\$161,705,920	18.03%	\$152,409,303	17.31%
Amount needed to be classified as "adequately capitalized"	\$53,820,300	6.00%	\$52,813,019	6.00%
Amount needed to be classified as "well capitalized"	\$62,790,350	7.00%	\$61,615,188	7.00%

Because the RBNWR is less than the net worth ratio, the Credit Union retains its original category of well capitalized. Furthermore in performing its calculation of total assets the Credit Union used the quarter end option, as permitted by regulation.

**NOTE 10: FAIR VALUES OF FINANCIAL
INSTRUMENTS**

The Fair Value Measurements and Disclosures Topic of the FASB ASC provides a framework for measuring fair value that requires an entity to derive fair value from the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date within its principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. To increase consistency and comparability in fair value measurements and related disclosures, a three-level hierarchy prioritizes the inputs to valuation techniques used to measure fair value with the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3) as further described below:

Level 1

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Credit Union has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 10: (continued)**Level 2**

Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include: quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are inactive; inputs other than quoted prices that are observable for the asset or liability; inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3

Level 3 inputs are unobservable inputs for the asset or liability which reflect the Credit Union's own assumptions about the assumptions that market participants would use in pricing the asset or liability. Assumptions about risk include risk inherent in a particular valuation technique used to measure fair value, typically pricing models and/or discounted cash flow methodologies.

The methodologies and associated inputs used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While the Credit Union believes its valuation methods and associated inputs are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The following tables set forth by level, within the fair value hierarchy, the Credit Union's financial instruments at fair value:

Assets at Fair Value as of December 31, 2011				
	Quoted Prices in Active Markets Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Level 1	Level 2	Level 3	Total
Assets:				
Federal agency securities	\$201,627,115	\$—	\$—	\$201,627,115
Mortgage-backed securities	70,638,399	—	—	70,638,399
	<u>\$272,265,514</u>	<u>\$—</u>	<u>\$—</u>	<u>\$272,265,514</u>

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 10: (continued)

Assets at Fair Value as of December 31, 2010

	Quoted Prices in Active Markets Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
Assets:				
Federal agency securities	\$182,214,469	\$—	\$—	\$182,214,469
Mortgage-backed securities	77,864,383	—	—	77,864,383
	<u>\$260,078,852</u>	<u>\$—</u>	<u>\$—</u>	<u>\$260,078,852</u>

The estimated fair value amounts have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of amounts that could be realized in a market exchange. The use of different assumptions and estimation methodologies may have a material effect on the estimated fair value amounts.

The following methods and assumptions were used to estimate fair value of each of the financial instruments for which it was practicable to estimate.

CASH AND CASH EQUIVALENTS/NON-NEGOTIABLE CERTIFICATES OF DEPOSIT

The carrying amount is a reasonable estimation of fair value due to the short-term nature of these instruments.

INVESTMENTS

Estimated fair values of investments are obtained from quoted market prices where available.

LOANS TO MEMBERS

The estimated fair value of variable-rate loans is the current carrying amount. The fair value of fixed-rate loans was estimated by discounting the estimated cash flows using the current rate at which similar loans would be issued.

ACCRUED INCOME RECEIVABLE

The carrying amount is a reasonable estimation of fair value.

MEMBERS' SHARE AND SAVINGS ACCOUNTS

The estimated fair value of demand deposit accounts (regular share, share draft, and money market accounts, etc.) is the carrying amount. The fair value of fixed-rate certificates was estimated by discounting the estimated cash flows using the current rate at which similar certificates would be issued.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 10: (continued)**COMMITMENTS TO EXTEND CREDIT**

The fair value of commitments to extend credit is equivalent to the amount of credit extended since the Credit Union does not charge fees to enter into these commitments and the commitments are not stated at fixed rates.

The carrying value and estimated fair value of the Credit Union's financial instruments are as follows:

	As of December 31, 2011		As of December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<i>Financial assets:</i>				
Cash and cash equivalents	\$36,710,383	\$36,710,383	\$20,637,102	\$20,637,102
Non-negotiable certificates of deposit	\$11,193,853	\$11,193,853	\$39,908,298	\$39,908,298
Investments:				
Available-for-sale	\$272,265,514	\$272,265,514	\$260,078,852	\$260,078,852
Held-to-maturity	\$264,623	\$232,155	\$1,207,321	\$1,196,983
Loans to members, net	\$538,537,221	\$549,077,131	\$520,476,803	\$526,458,224
Accrued interest receivable	\$2,718,699	\$2,718,699	\$3,329,212	\$3,329,212
<i>Financial liabilities:</i>				
Members' share and savings accounts	\$725,625,623	\$729,820,875	\$718,511,847	\$723,124,608
<i>Unrecognized financial instruments:</i>				
Commitments to extend credit	\$—	\$223,323,000	\$—	\$232,410,000

NOTE 11: INDUSTRY EVENTS

In January 2009, the NCUA informed federally-insured credit unions that it was taking actions to enhance and support the corporate credit union system as well as the NCUSIF. In addition to placing U.S. Central Federal Credit Union into conservatorship, the NCUA established the Temporary Corporate Credit Union Share Guarantee Program, whereby all deposits in excess of insurable limits maintained at corporate credit unions, other than membership capital shares and perpetual contributed capital, will be guaranteed through December 31, 2012.

The losses recognized by many natural person credit unions from their at-risk investments in corporate credit unions, coupled with high loan losses and other non-corporate investment losses, resulted in regulatory actions by the NCUA, including conservatorship, assisted mergers, and liquidations. All of these factors have contributed to significant losses to the NCUSIF and resulted in annual assessments of insurance premiums by the NCUA Board.

<p style="text-align: center;">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
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Note 11: (continued)

During June 2009, legislation was created to establish a Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) to absorb the corporate stabilization costs by borrowing money from the U.S. Treasury. During September 2010, the NCUA received approval from the U.S. Treasury to extend the life of the Stabilization Fund to June 2021. The funds borrowed from the U.S. Treasury will be repaid from assessments authorized by the NCUA Board. The NCUA Board has levied assessments during 2010 and 2011 to repay borrowed funds to the U.S. Treasury. It is anticipated that the NCUA Board will be making annual assessments over at least the next several years to cover costs associated with the corporate credit union system.

★★★★★★

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INDEPENDENT AUDITOR'S REPORT

March 18, 2013

To the Supervisory Committee of
Commonwealth Credit Union

We have audited the accompanying financial statements of Commonwealth Credit Union, which comprise the statements of financial condition as of December 31, 2012 and 2011, and the related statements of income, comprehensive income, members' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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To the Supervisory Committee of
Commonwealth Credit Union
Page 2

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Credit Union as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Orth, Chakler, Murnane & Co.

Orth, Chakler, Murnane & Company
Certified Public Accountants
Miami, FL

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COMMONWEALTH CREDIT UNION STATEMENTS OF FINANCIAL CONDITION
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ASSETS

	As of December 31,	
	2012	2011
Cash and cash equivalents	\$47,686,053	\$36,710,383
Non-negotiable certificates of deposit	5,416,000	11,193,853
Investments:		
Available-for-sale	287,223,889	272,265,514
Held-to-maturity	—	264,623
Loans to members, net of allowance for loan losses	550,349,290	538,537,221
Accrued interest receivable	2,905,005	2,718,699
Other real estate owned	609,465	630,684
Prepaid and other assets	3,557,796	5,930,766
Property and equipment	20,313,334	19,133,725
NCUSIF deposit	7,567,323	7,216,247
Federal Home Loan Bank stock	1,711,300	1,711,300
Perpetual contributed capital at corporate credit unions	691,986	691,986
Total assets	\$928,031,441	\$897,005,001

LIABILITIES AND MEMBERS' EQUITY

	As of December 31,	
	2012	2011
LIABILITIES:		
Members' share and savings accounts	\$742,359,541	\$725,625,623
Accounts payable	5,562,230	4,216,802
Accrued liabilities	4,189,341	4,652,418
Total liabilities	<u>752,111,112</u>	<u>734,494,843</u>
Commitments and contingent liabilities		
MEMBERS' EQUITY:		
Regular reserve	20,827,421	20,827,421
Undivided earnings	154,108,033	140,878,499
Accumulated other comprehensive income	984,875	804,238
Total members' equity	<u>175,920,329</u>	<u>162,510,158</u>
Total liabilities and members' equity	\$928,031,441	\$897,005,001

The accompanying notes are an integral part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF INCOME

	For the years ended December 31,	
	2012	2011
INTEREST INCOME:		
Loans to members	\$34,958,046	\$34,112,363
Investments	2,987,387	3,746,197
Total interest income	37,945,433	37,858,560
INTEREST EXPENSE:		
Members' share and savings accounts	3,998,835	6,025,664
Borrowed funds	324	497
Total interest expense	3,999,159	6,026,161
Net interest income	33,946,274	31,832,399
PROVISION FOR LOAN LOSSES	3,280,672	3,684,692
Net interest income after provision for loan losses	30,665,602	28,147,707
NON-INTEREST INCOME:		
Fees and service charges	12,007,371	11,921,055
	42,672,973	40,068,762
NON-INTEREST EXPENSE:		
Compensation and employee benefits	17,502,414	18,603,136
Office operating and occupancy	9,666,769	9,062,362
Corporate credit union stabilization fund assessments	704,646	1,766,562
Miscellaneous operating	1,569,610	1,340,085
Total non-interest expense	29,443,439	30,772,145
Net income	\$13,229,534	\$9,296,617

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF COMPREHENSIVE INCOME

	For the years ended December 31,	
	2012	2011
NET INCOME	\$13,229,534	\$9,296,617
OTHER COMPREHENSIVE INCOME/(LOSS):		
Net unrealized holding losses arising during the year on investments classified as available-for-sale	(68,817)	(247,603)
Reclassification adjustments for losses included in net income	249,454	—
Other comprehensive income/(loss)	180,637	(247,603)
Comprehensive income	\$13,410,171	\$9,049,014

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF MEMBERS' EQUITY
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For the years ended December 31, 2012 and 2011				
	Regular Reserve	Undivided Earnings	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2010	\$20,827,421	\$131,581,882	\$1,051,841	\$153,461,144
Net income	—	9,296,617	—	9,296,617
Other comprehensive loss	—	—	(247,603)	(247,603)
Balance, December 31, 2011	20,827,421	140,878,499	804,238	162,510,158
Net income	—	13,229,534	—	13,229,534
Other comprehensive income	—	—	180,637	180,637
Balance, December 31, 2012	\$20,827,421	\$154,108,033	\$984,875	\$175,920,329

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF CASH FLOWS

	For the years ended December 31,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$13,229,534	\$9,296,617
Adjustments:		
Provision for loan losses	3,280,672	3,684,692
Depreciation	1,544,372	1,740,299
Amortization of deferred loan origination fees/costs	736,386	569,326
Loss/(gain) on sale of other real estate owned	72,591	(29,655)
Amortization/accretion of investment premiums/discounts, net	2,721,158	2,608,683
Loss on sale of investments	249,454	—
Gain on sale of fixed assets	—	(22,592)
Changes in operating assets and liabilities:		
Accrued income receivable	(186,306)	610,513
Prepaid and other assets	2,372,970	(3,102,446)
Accounts payable and accrued liabilities	(221,249)	625,234
Net cash provided by operating activities	23,799,582	15,980,671
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities, sales, and repayments of available-for-sale securities	329,120,097	338,381,988
Purchase of available-for-sale securities	(346,834,489)	(353,421,629)
Proceeds from maturities and repayments of held-to-maturity securities	230,665	939,391
Change in NCUSIF deposit	(351,076)	161,305
Net change in loans, net of charge-offs	(17,136,432)	(23,275,376)
Recoveries on loans charged off	926,397	663,663
Net change in non-negotiable certificates of deposit	5,777,853	28,714,445
Expenditures for property and equipment	(1,620,381)	(267,585)
Proceeds from sale of other real estate owned	376,436	665,072
Purchase of 1 st mortgage for other real estate owned	(46,900)	—
Proceeds from sale of fixed assets	—	417,560
Net cash used in investing activities	(29,557,830)	(7,021,166)

The accompanying notes are an integral part of these financial statements.

COMMONWEALTH CREDIT UNION STATEMENTS OF CASH FLOWS

Cash Flows: (continued)

	For the years ended December 31,	
	2012	2011
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in members' share and savings accounts	16,733,918	7,113,776
Net cash provided by financing activities	16,733,918	7,113,776
Net change in cash and cash equivalents	10,975,670	16,073,281
Cash and cash equivalents at beginning of year	36,710,383	20,637,102
Cash and cash equivalents at end of year	\$47,686,053	\$36,710,383
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Interest paid	\$3,999,159	\$6,026,161
SCHEDULE OF NON-CASH TRANSACTIONS:		
Land purchase commitment	\$1,103,600	\$—
Transfers from loans to members to other real estate owned	\$380,908	\$297,277
Transfers from membership capital shares at corporate credit unions to perpetual contributed capital at corporate credit unions	\$—	\$691,986
Other comprehensive income/(loss)	\$180,637	(\$247,603)

The accompanying notes are an integral
part of these financial statements.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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***NOTE 1: SIGNIFICANT
ACCOUNTING POLICIES***

ORGANIZATION

Commonwealth Credit Union (the Credit Union) is a cooperative association organized in accordance with Chapter 290 of the Kentucky State Chartered Credit Union Law. Participation in the Credit Union is limited to those individuals that qualify for membership. The field of membership is defined in the Credit Union's Charter and Bylaws.

FINANCIAL STATEMENTS/USE OF ESTIMATES

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP/USA) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the periods then ended. Estimates that are particularly susceptible to change relate to the determination of the allowance for loan losses and the fair value of financial instruments. The significant accounting principles and policies used in the preparation of these financial statements, together with certain related information, are summarized below.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include amounts due from banks and credit unions and cash on hand. Amounts due from banks and credit unions may, at times, exceed federally insured limits.

INVESTMENTS

Investments are classified into the following categories: held-to-maturity and available-for-sale. Investment securities classified as held-to-maturity are measured at amortized cost. This classification is based upon the Credit Union's intent and ability to hold these investment securities to full maturity. Investment securities classified as available-for-sale are measured at fair value as of the statement of financial condition date. Unrealized gains and losses for available-for-sale investments are reported as a separate component of members' equity.

Investments are adjusted for the amortization of premiums and accretion of discounts as an adjustment to interest income on investments over the term of the investment by a method which approximates the interest method. Realized gains and losses on disposition, if any, are computed using the specific identification method.

MEMBERSHIP CAPITAL SHARES/PERPETUAL CONTRIBUTED CAPITAL AT CORPORATE CREDIT UNIONS

Membership capital shares can only be withdrawn after providing three-years notice. During 2011, KyCorp converted the existing membership capital shares to perpetual contributed capital to meet the requirements of the newly revised National Credit Union Administration (NCUA) Regulations. As a result, the Credit Union agreed to the conversion of its existing membership capital shares to perpetual contributed capital. Perpetual contributed capital is not insured, has no maturity, and would not be returned to the Credit Union upon request without the approval of the NCUA. Perpetual contributed capital could be sold to another credit union if the Credit Union could find a willing buyer.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 1: (continued)

FEDERAL HOME LOAN BANK (FHLB) STOCK

As a member of the FHLB, the Credit Union is required to make a minimum stock investment with the FHLB based on a formula developed by the FHLB that considers the Credit Union's total assets and outstanding advances from the FHLB. No ready market exist for the FHLB stock and it has no quoted market price.

LOANS TO MEMBERS AND ALLOWANCE FOR LOAN LOSSES

Loans to members are stated at the amount of unpaid principal, net of an allowance for loan losses (ALL) and deferred loan origination fees and costs. The ALL is increased by a provision for loan losses charged to expense and decreased by charge-offs (net of recoveries).

The ALL is maintained at an amount that represents management's estimate of losses that may be sustained in the liquidation of currently outstanding loans. Management's periodic evaluation of the adequacy of the ALL account is based on the Credit Union's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and current economic conditions that may affect the borrower's ability to repay.

Interest on loans is recognized over the terms of the loans and is calculated on principal amounts outstanding. The accrual of interest is discontinued when a loan exceeds 90 days delinquent or when management believes that collection of interest is doubtful. Loan fees which are charged to members and direct origination costs on indirect vehicle loans are deferred and amortized as an adjustment of loan yield over the estimated life of the loan using a method that approximates the interest method. Direct loan origination costs on consumer loans are recognized in expenses when incurred. This is not materially different from expenses that would have been recognized under the provisions of the Nonrefundable Fees and Other Costs Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC).

ALL METHODOLOGY

Management has an established methodology to determine the adequacy of the ALL that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the ALL, the Credit Union has segmented certain loans in the portfolio by product type. Loans are divided into the following segments: consumer, real estate, and commercial. The Credit Union divides these segments into classes based on the associated risks within those segments. Consumer loans are divided into the following classes: Vehicle, Unsecured, and Other Secured. Member owned real estate loans are divided into the following classes: First and Second Mortgages and Home Equity Loans. Commercial loans are Business Partners (BP), Inc, participation loans primarily secured by commercial real estate.

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**
Note 1: (continued)

Each class of loans requires significant judgment to determine the estimation method that fits the credit risk characteristics of its portfolio segment. The Credit Union uses both internally developed and vendor supplied models in the process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the ALL are periodically reviewed to ensure the theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented. The following describes management's methodology for determining the ALL for loan losses estimate for each segment or class of loans.

CONSUMER PORTFOLIO SEGMENT ALL METHODOLOGY

For consumer loans, the Credit Union determines the ALL on a collective basis utilizing historical loss ratios to represent the best estimate of incurred losses at the measurement date. Loans are pooled generally by loan types with similar risk characteristics. The historical ratios used to measure the incurred losses in each loan type were developed from the 12-month historical data as of December 31, 2012, and the 36-month historical data as of December 31, 2011. The consumer ALL model primarily uses historic default experience. The consumer ALL also includes an estimate for losses on individually evaluated consumer loans over six months delinquent.

REAL ESTATE PORTFOLIO SEGMENT ALL METHODOLOGY

For real estate loans, the Credit Union determines the ALL on a collective basis utilizing historical loan loss ratios to represent the best estimate of incurred losses at the measurement date. Loans are pooled by loan types with similar risk characteristics. The historical ratios used to measure the incurred losses in each loan type were developed from the 12-month historical data as of December 31, 2012, and the 36-month historical data as of December 31, 2011. The real estate ALL model primarily uses historic default experience. The real estate ALL also includes an estimate for losses on individually evaluated real estate loans over six months delinquent.

COMMERCIAL PORTFOLIO SEGMENT ALL METHODOLOGY

Commercial loans are individually reviewed for potential losses. Based on credit risk assessments and management's analysis of leading predictors of losses, a loss multiplier is applied to individual loan balances. These loss estimates are adjusted as appropriate based on predetermined ranges based on BP annual review ratings, analysis of long-term average loss experience compared to previously forecasted losses, external loss data or other risks identified from current economic conditions and credit quality trends.

LOAN CHARGE-OFF POLICIES

The Credit Union's quality control process includes preparing lists to monitor and track delinquent loans. Tracking the loans on these lists enables management to assess the performance of the loan portfolio and act to mitigate risk therein through necessary changes in policy and procedures. The quality control process also serves as a tool to assist the Credit Union in identifying loans for charge off on a timely basis. The following is a description of the Credit Union's loan charge-off policies:

<p style="text-align: center;">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>
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Note 1: (continued)

Consumer, real estate and commercial loans are generally charged off when:

- The loan has been determined to be uncollectible by the Collection Manager regardless of the number of months delinquent.
- Repayment is deemed to be protracted beyond reasonable time frames.
- The loan is a deficiency balance from the sale of collateral and the borrower has indicated an unwillingness to make further payments, and there are no other tangible assets.
- Loans included in Chapter 7 Bankruptcy when the member is not reaffirming and the Bankruptcy Judge will grant discharge of the debt.
- Unsecured loans included in Chapter 13 Bankruptcy and the Bankruptcy Trustee has confirmed the Plan. Secured loans with balances in excess of the value of the collateral held at the time of the final confirmation will be "written down" in a partial charge-off to the actual value of the collateral.
- The remaining balance on a delinquent loan, when the Credit Union agrees to "settle" the loan for an amount less than the outstanding balance.
- The borrower is determined to be a "skip" and the Credit Union has been unable to establish any contact with the borrower for 180 days.
- Fraud has been committed and there is no realistic chance of recovery.
- The loan is 180 days or more delinquent, unless one or more of the following conditions exist:
 - The loan is well secured.
 - The Credit Union or the member is waiting on a settlement of a documented insurance/bond claim that will be paid in a reasonable period of time.
 - The member is deceased and the Credit Union has substantial reason to expect settlement from the estate, co-borrower or relatives in a reasonable period of time.
 - The Credit Union is waiting on proceeds related to the sale of repossessed collateral, a refund of collateral protection insurance is expected, extended warranty refund is expected or any other repossession related refunds are anticipated.
 - The Credit Union has pending litigation concerning the loan and expects to receive a favorable judgment and avenue of collection.
 - The Credit Union has made arrangements or has a reasonable expectation that the recovery of the delinquent funds will be made.

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**
Note 1: (continued)
OTHER REAL ESTATE OWNED

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell.

PROPERTY AND EQUIPMENT

Land is carried at cost. Property and equipment are carried at cost less accumulated depreciation. Buildings, and furniture and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. The Credit Union reviews property and equipment (long-lived assets) for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

NCUSIF DEPOSIT

The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with NCUA regulations, which require the maintenance of a deposit by each federally insured credit union in an amount equal to 1% of its insured members' shares. The deposit would be refunded to the Credit Union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board.

CORPORATE CREDIT UNION STABILIZATION FUND ASSESSMENTS

During September 2011 and July 2012, the NCUA Board approved 25 and 9.5 basis point assessments to fund the corporate credit union stabilization fund. These assessments were based on the Credit Union's insured shares as of June 30, 2011 and 2012, respectively. (See Note 11)

MEMBERS' SHARE AND SAVINGS ACCOUNTS

Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Interest on members' share and savings accounts is based on available earnings at the end of an interest period and is not guaranteed by the Credit Union. Interest rates on members' share accounts are ratified by the Board of Directors, based on an evaluation of current and future market conditions.

MEMBERS' EQUITY

The Credit Union is required to maintain a statutory reserve (regular reserve) in accordance with the Federal Credit Union Act. This statutory reserve represents a regulatory restriction and is not available for the payment of interest.

FEDERAL AND STATE TAX EXEMPTION

The Credit Union is exempt from most federal, state, and local taxes under the provisions of the Internal Revenue Code and state tax laws. The Income Taxes Topic of the FASB ASC clarifies accounting for uncertainty in income taxes reported in the financial statements. The interpretation provides criteria for assessment of individual tax positions and a process for recognition and measurement of uncertain tax positions. Tax positions are evaluated on whether they meet the "more likely than not" standard for sustainability upon examination by tax authorities. The Credit Union is a state-chartered credit union as defined in Internal Revenue Code (IRC) Section 501(c)(14). As

**COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS**
Note 1: (continued)

such, the Credit Union is exempt from federal taxation of income derived from the performance of activities directly related to its exempt purposes. However, IRC Section 511 imposes a tax on the unrelated business income (UBI) derived by state-chartered credit unions.

Beginning in March 2008, the Internal Revenue Service (IRS) released Technical Advice Memorandums (TAMs) to specific state-chartered credit unions specifying the revenue sources subject to unrelated business income tax (UBIT). UBI may also be subject to tax in certain states. Management has assessed the Credit Union's activities and any potential federal or state income tax liability and determined that the Credit Union has no uncertain tax positions that qualify for either recognition or disclosure in the financial statements. Additionally, no interest and penalties have been recorded in the accompanying financial statements related to uncertain tax positions. Currently, the 2011, 2010, and 2009 federal income tax returns are open for examination by the IRS. The filing years open for examination by the state, if applicable, may be equal to, greater than or less than the years open for examination by the IRS.

SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 18, 2013, the date the financial statements were available to be issued. Management has not identified any items requiring recognition or disclosure.

NEW ACCOUNTING PRONOUNCEMENTS

A new accounting pronouncement has been issued by the Governmental Accounting Standards Board (GASB) to amend Statement No. 27 as it relates to Accounting and Financial Reporting for Pensions by governmental entities. The Credit Union's employees participate in a government sponsored pension plan. This proposal requires the governmental entity to recognize the actuarial projected benefit obligation due to employees under a state sponsored defined benefit pension plan. Currently, the pension plan only requires the Credit Union to reimburse the plan for the current obligations due to employees enrolled in the plan. However, the new accounting pronouncement requires the Credit Union to record a liability based on the actuarial projected benefit obligation. The Credit Union is not subject to GASB but is required to account for liabilities based on GAAP/USA. Under GAAP/USA, a liability has been incurred if it is probable of payment and the amount can be measured. Management has acknowledged that this liability is probable of payment; however, the liability could not be measured as of December 31, 2012, since the records needed to measure this liability reside with the Kentucky Retirement System (KRS).

The new GASB amendment is required to be implemented for periods beginning after June 15, 2013. KRS has indicated that they will provide a plan of implementation by December 31, 2013, and record the entry on the KRS accounting records by June 30, 2014. In addition, KRS will provide the state agencies and the Credit Union with a plan for implementation by December 31, 2014, and the state agencies and the Credit Union will be required to comply with the implementation plan by June 30, 2015. The Credit Union expects to receive the measurement information needed to record the liability during the implementation planning stage or approximately December 31, 2014, and record a liability at that time. The liability is expected to be substantial and will be established with a charge to undivided earnings and will reduce the Credit Union's net worth ratio. (See Note 9)

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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NOTE 2: INVESTMENTS

The amortized cost and estimated fair value of investments are as follows:

As of December 31, 2012				
<u>Available-for-sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Collateralized mortgage obligations	\$130,733,300	\$794,233	(\$125,371)	\$131,402,162
Federal agency securities	123,774,811	233,921	(5,822)	124,002,910
Mortgage-backed securities	22,719,449	42,170	—	22,761,619
Corporate bonds	9,011,454	45,744	—	9,057,198
	<u>\$286,239,014</u>	<u>\$1,116,068</u>	<u>(\$131,193)</u>	<u>\$287,223,889</u>

As of December 31, 2011				
<u>Available-for-sale:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Federal agency securities	\$201,466,939	\$170,921	(\$10,745)	\$201,627,115
Mortgage-backed securities	69,994,337	916,809	(272,747)	70,638,399
	<u>\$271,461,276</u>	<u>\$1,087,730</u>	<u>(\$283,492)</u>	<u>\$272,265,514</u>

As of December 31, 2011				
<u>Held-to-maturity:</u>	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage-backed securities	\$264,623	\$—	(\$32,468)	\$232,155

The amortized cost and estimated fair value of investments by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay certain obligations without call or prepayment penalties.

As of December 31, 2012		
<u>Available-for-sale</u>		
	Amortized Cost	Fair Value
Within 1 year	\$35,193,485	\$35,222,000
1 to 5 years	97,592,780	97,838,108
	132,786,265	133,060,108
Collateralized mortgage obligations	130,733,300	131,402,162
Mortgage-backed securities	22,719,449	22,761,619
	<u>\$286,239,014</u>	<u>\$287,223,889</u>

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 2: (continued)

The following tables show the gross unrealized losses and fair value of investments, aggregated by length of time individual securities have been in a continuous unrealized loss position.

As of December 31, 2012						
<i>Available-for-sale</i>						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
Collateralized mortgage obligations	\$49,451,919	(\$125,371)	\$—	\$—	\$49,451,919	(\$125,371)
Federal agency securities	9,325,110	(5,822)	—	—	9,325,110	(5,822)
	<u>\$58,777,029</u>	<u>(\$131,193)</u>	<u>\$—</u>	<u>\$—</u>	<u>\$58,777,029</u>	<u>(\$131,193)</u>

As of December 31, 2011						
<i>Available-for-sale</i>						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
Federal agency securities	\$26,266,385	(\$10,745)	\$—	\$—	\$26,266,385	(\$10,745)
Mortgage-backed securities	23,272,357	(221,722)	3,818,554	(51,025)	27,090,911	(272,747)
	<u>\$49,538,742</u>	<u>(\$232,467)</u>	<u>\$3,818,554</u>	<u>(\$51,025)</u>	<u>\$53,357,296</u>	<u>(\$283,492)</u>

As of December 31, 2011						
<i>Held-to-maturity</i>						
	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	Fair	Gross	Fair	Gross	Fair	Gross
	Value	Unrealized	Value	Unrealized	Value	Unrealized
		Losses		Losses		Losses
Mortgage-backed securities	\$—	\$—	\$232,155	(\$32,468)	\$232,155	(\$32,468)

Unrealized losses on securities issued by the U.S. Government and its agencies have not been recognized into income because the implied guarantee of the principal balances of these securities by the U.S. Government. The decline in the fair values of the investment securities is primarily due to differences between security yields and market interest rates. The fair values of the securities are expected to be recovered as the approach their maturity date. Management has the ability to hold these securities until recovery, which may be maturity.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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NOTE 3: LOANS TO MEMBERS

The composition of loans to members is as follows:

	As of December 31,	
	2012	2011
Consumer:		
Direct new auto	\$10,372,623	\$12,053,872
Direct used auto	63,034,111	66,644,856
Indirect new auto	26,216,473	26,732,658
Indirect used auto	64,327,893	56,982,450
Unsecured personal loans	52,527,097	48,211,487
Unsecured credit card loans	66,489,194	64,222,352
Other secured	7,375,884	7,473,525
Total consumer	<u>290,343,275</u>	<u>282,321,200</u>
Real Estate:		
First and second mortgage	207,906,634	196,719,851
Home equity line of credit (HELOC)	44,996,383	47,062,285
Total real estate	<u>252,903,017</u>	<u>243,782,136</u>
Commercial:		
Real estate	11,849,208	17,404,371
Total commercial	<u>11,849,208</u>	<u>17,404,371</u>
Total loans	555,095,500	543,507,707
Net deferred loan origination fees/costs	762,424	702,338
	555,857,924	544,210,045
Less ALL	<u>(5,508,634)</u>	<u>(5,672,824)</u>
	<u>\$550,349,290</u>	<u>\$538,537,221</u>

A summary of the activity in the ALL is as follows:

	For the years ended December 31, 2012 and 2011			
	Consumer	Real Estate	Commercial	Total
Balance,				
December 31, 2010	\$4,813,748	\$48,283	\$344,853	\$5,206,884
Provision for loan losses	2,094,271	145,732	1,444,689	3,684,692
Recoveries	660,211	3,452	—	663,663
Loans charged off	(3,091,733)	(100,150)	(690,532)	(3,882,415)
Balance,				
December 31, 2011	4,476,497	97,317	1,099,010	5,672,824
Provision for loan losses	3,313,024	64,616	(96,968)	3,280,672
Recoveries	791,040	17,293	118,064	926,397
Loans charged off	(3,952,874)	(99,848)	(318,537)	(4,371,259)
Balance,				
December 31, 2012	<u>\$4,627,687</u>	<u>\$79,378</u>	<u>\$801,569</u>	<u>\$5,508,634</u>

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 3: (continued)

		As of December 31, 2012		
		Consumer	Real Estate	Commercial
Individually evaluated for impairment		\$—	\$—	\$801,569
Collectively evaluated for impairment		\$4,627,687	\$79,378	\$—
				\$4,707,065

		As of December 31, 2011		
		Consumer	Real Estate	Commercial
Individually evaluated for impairment		\$—	\$—	\$613,218
Collectively evaluated for impairment		\$4,476,497	\$97,317	\$485,792
				\$5,059,606

A summary of the recorded investment in loans by portfolio segment is as follows:

		As of December 31, 2012		
		Consumer	Real Estate	Commercial
Ending balance		\$291,105,700	\$252,903,016	\$11,849,208
Individually evaluated for impairment		\$—	\$—	\$11,849,208
Collectively evaluated for impairment		\$291,105,700	\$252,903,016	\$—
				\$544,008,716

		As of December 31, 2011		
		Consumer	Real Estate	Commercial
Ending balance		\$283,023,537	\$243,782,137	\$17,404,371
Individually evaluated for impairment		\$262,860	\$368,986	\$3,488,243
Collectively evaluated for impairment		\$282,760,677	\$243,413,151	\$13,916,128
				\$540,089,956

IMPAIRED LOANS

A loan is impaired when it is probable, based on current information and events, the credit union will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement.

The following tables include the recorded investment and unpaid principal balances for impaired loans with the associated ALL amount, if applicable. Management determined the specific ALL based on but not limited to the payment history, legal status, risk rating, reduction in rental payments or occupancy rates supporting the loan, failure to pay taxes or provide key financial information requested as an on-going condition of the loan and other information as applicable. In those cases, the current fair value of the collateral, less selling costs, was used to determine the specific ALL recorded. Also presented is the average recorded investment in the impaired loans and the related amount of interest recognized during the time within the period that the impaired loans were impaired. The average balances are calculated based on the month-end balances of the loans of the period reported.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 3: (continued)

The tables below summarize key information for impaired loans:

As of and for the year ended December 31, 2012	Recorded Investment	Unpaid Principal Balance	Specific Allowance	Average Recorded Investment	Interest Income Recognized
<u>With no related allowance:</u>					
Consumer:					
Direct auto loans	\$766,200	\$766,200	\$—	\$744,629	\$34,630
Real Estate:					
First and second mortgages	\$249,786	\$249,786	\$—	\$252,311	\$12,156
HELOC	\$27,193	\$27,193	\$—	\$28,427	\$2,011
Commercial:					
Real estate	\$525,169	\$525,169	\$—	\$527,038	\$38,255
<u>With an allowance recorded:</u>					
Commercial:					
Real estate	\$3,731,142	\$3,592,283	\$801,569	\$3,286,548	\$206,135
Totals:					
Consumer	\$766,200	\$766,200	\$—	\$744,629	\$34,630
Real Estate	276,979	276,979	—	280,738	14,167
Commercial	4,256,311	4,117,452	801,569	3,813,586	244,390
	<u>\$5,299,490</u>	<u>\$5,160,631</u>	<u>\$801,569</u>	<u>\$4,838,953</u>	<u>\$293,187</u>

As of and for the year ended December 31, 2011	Recorded Investment	Unpaid Principal Balance	Specific Allowance	Average Recorded Investment	Interest Income Recognized
<u>With no related allowance:</u>					
Consumer:					
Direct auto loans	\$139,344	\$138,344	\$—	\$146,318	\$7,837
Indirect auto loans	\$125,066	\$124,516	\$—	\$140,647	\$5,271
Real Estate:					
First/Second mortgage	\$338,852	\$338,852	\$—	\$361,510	\$17,420
HELOC	\$30,134	\$30,134	\$—	\$31,554	\$1,935
Commercial:					
Real estate	\$354,208	\$354,047	\$—	\$467,955	\$17,797
<u>With an allowance recorded:</u>					
Commercial:					
Real estate	\$3,377,150	\$3,134,196	\$613,218	\$3,599,640	\$166,074
Totals:					
Consumer	\$264,410	\$262,860	\$—	\$286,965	\$13,108
Real Estate	368,986	368,986	—	393,064	19,355
Commercial	3,731,358	3,488,243	613,218	4,067,595	183,871
	<u>\$4,364,754</u>	<u>\$4,120,089</u>	<u>\$613,218</u>	<u>\$4,747,624</u>	<u>\$216,334</u>

COMMONWEALTH CREDIT UNION

NOTES TO THE FINANCIAL STATEMENTS

Note 3: (continued)

The tables below provide an age analysis of past due loans by class:

As of December 31, 2012							
	Days Delinquent				Total Delinquent Loans	Total Current Loans	Total Loans
	30 - 60	61 - 90	91 - 180	Over 180			
Consumer:							
Direct Auto	\$785,026	\$319,304	\$452,788	\$71,914	\$1,629,032	\$71,777,702	\$73,406,734
Indirect Auto	2,297,918	839,079	775,405	149,505	4,061,907	87,244,883	91,306,790
Unsecured Personal	516,190	297,668	348,709	55,150	1,217,717	51,309,380	52,527,097
Unsecured Credit Card	521,715	162,487	278,553	71,120	1,033,875	65,455,319	66,489,194
Other secured	11,015	2,740	32,289	9,983	56,027	7,319,857	7,375,884
Real Estate:							
First/Second mortgage	210,462	\$24,034	129,926	77,464	741,886	207,164,748	207,906,634
HELOC	235,701	62,878	38,019	53,619	390,217	44,606,166	44,996,383
Commercial:							
Real estate	309	295,449	—	380,495	676,253	11,172,955	11,849,208
Total	\$4,578,336	\$2,303,639	\$2,055,689	\$869,250	\$9,806,914	\$546,051,010	\$555,857,924

As of December 31, 2011							
	Days Delinquent				Total Delinquent Loans	Total Current Loans	Total Loans
	30 - 60	61 - 90	91 - 180	Over 180			
Consumer:							
Direct Auto	\$572,011	\$218,649	\$380,068	\$331,616	\$1,502,344	\$77,196,384	\$78,698,728
Indirect Auto	907,058	204,429	216,379	183,182	1,511,048	82,906,398	84,417,446
Unsecured Personal	305,338	174,653	171,026	22,102	673,119	47,538,368	48,211,487
Unsecured Credit Card	347,205	172,694	205,560	12,190	737,649	63,484,703	64,222,352
Modified Loans	72,745	73,464	53,684	1,541	201,434	—	—
Other secured	17,532	4,682	14,323	24,074	60,611	7,412,914	7,473,525
Real Estate:							
First/Second mortgage	267,283	77,944	145,269	687,932	1,178,428	195,541,423	196,719,851
HELOC	119,645	28,704	98,077	98,830	345,256	46,717,029	47,062,285
Commercial:							
Real estate	—	—	696,163	455,741	1,151,904	16,252,467	17,404,371
Total	\$2,608,817	\$955,219	\$1,980,549	\$1,817,208	\$7,361,793	\$537,049,686	\$544,210,045

The Credit Union places loans on non-accrual status when the full and timely collection of interest or principal becomes uncertain, part of the principal balance has been charged-off and no restructuring has occurred or the loans reach 90 days past due. Loans on which the accrual of interest has been discontinued or reduced approximated \$1,652,000 and \$3,798,000 as of December 31, 2012 and 2011, respectively. There were no loans 90 days or more past due and still accruing interest as of December 31, 2012 or 2011.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 3: (continued)

TROUBLED DEBT RESTRUCTURING/MODIFICATIONS

The Credit Union's loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (TDR), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Credit Union's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions.

When the Credit Union modifies a collateral dependent loan, management uses the current fair value of the collateral, less selling costs, to determine the net realizable value of the collateral. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through the ALL.

The following tables include the recorded financial impact of TDRs as of December 31, 2012 and 2011. Below is the recorded investment in TDRs modified within the last year as well as TDRs that defaulted in the current reporting period. The Credit Union defines a TDR as subsequently defaulted when the member fails to complete six consecutive payments, or the member files bankruptcy.

For the year ended December 31, 2012			
	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	TDRs which subsequently defaulted
Real Estate:			
First and second mortgage	\$260,468	\$249,786	\$—
HELOC	31,264	27,193	—
Commercial:			
Real estate	1,888,529	1,549,953	236,491
Total	<u>\$2,180,261</u>	<u>\$1,826,932</u>	<u>\$236,491</u>

For the year ended December 31, 2011			
	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	TDRs which subsequently defaulted
Real Estate:			
First and second mortgage	\$398,147	\$222,096	\$47,972
HELOC	31,541	30,134	—
Commercial:			
Real estate	1,856,069	1,392,453	521,287
Total	<u>\$2,285,757</u>	<u>\$1,644,683</u>	<u>\$569,259</u>

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 3: (continued)

COMMERCIAL CREDIT QUALITY INDICATORS

The following tables represent commercial credit exposures by creditworthiness category. The use of creditworthiness categories to grade loans permits management's use of migration analysis to estimate a portion of credit risk. The Credit Union's internal creditworthiness grading system is based on experiences with similarly graded loans. Category ratings are reviewed at least each quarter, at which time management analyzes the resulting scores, as well as other external statistics and factors, to track the migration of loan performance. Loans that trend upward toward higher quality levels generally have a lower risk factor associated. Whereas, loans that migrate toward a lower credit rating generally will result in a higher risk factor being applied to those related loan balances.

The internal risk ratings for Business Partner, Inc., participation loans are as follows:

Commercial Credit Quality Indicators
As of December 31, 2012

	Total
1 - Excellent	\$—
2 - Strong	534,701
3 - Satisfactory	5,095,525
4 - Watch list	2,102,157
5 - Special mention	1,701,264
6 - Substandard	699,381
7 - Loss	1,716,180
	\$11,849,208

Commercial Credit Quality Indicators
As of December 31, 2011

	Total
1 - Excellent	\$—
2 - Strong	232,861
3 - Satisfactory	6,110,118
4 - Watch list	3,664,567
5 - Special mention	4,301,593
6 - Substandard	1,883,541
7 - Loss	1,211,691
	\$17,404,371

CONSUMER AND REAL ESTATE CREDIT QUALITY INDICATORS

The Credit Union categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation and current economic trends among other factors. This analysis is performed monthly. The Credit Union uses the following definitions for risk ratings:

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 3: (continued)

- **Special Mention.** Loans are classified as special mention when it is determined a loan relationship should be monitored more closely. Loans that are 60 days to 89 days past due are classified as special mention.
- **Substandard.** Loans that are 90 to 365 days past due are classified as substandard. Substandard assets include those characterized by the distinct possibility that the Credit Union will sustain some loss if the deficiencies are not corrected.
- **Doubtful.** Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable. These loans are greater than 365 days past due.

Loans not meeting the criteria as part of the above described process are considered to be pass rated loans. Pass rated loans are generally well protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. Pass rated assets are not more than 59 days past due but are generally performing in accordance with the loan terms.

The tables below summarize key information for real estate credit quality:

Real Estate Credit Quality Indicators
As of December 31, 2012

	Pass	Special Mention	Substandard	Doubtful	Total
First/Second Mortgage	\$207,174,958	\$453,961	\$77,465	\$200,250	\$207,906,634
HELOC	44,841,866	100,898	53,619	—	44,996,383
	<u>\$252,016,824</u>	<u>\$554,859</u>	<u>\$131,084</u>	<u>\$200,250</u>	<u>\$252,903,017</u>

Real Estate Credit Quality Indicators
As of December 31, 2011

	Pass	Special Mention	Substandard	Doubtful	Total
First/Second Mortgage	\$195,808,705	\$223,213	\$535,771	\$152,162	\$196,719,851
HELOC	46,836,674	126,781	49,685	49,145	47,062,285
	<u>\$242,645,379</u>	<u>\$349,994</u>	<u>\$585,456</u>	<u>\$201,307</u>	<u>\$243,782,136</u>

METHODOLOGY CHANGES

During 2012, management changed the methodology to estimate loan losses for the real estate and consumer loan portfolios. Specifically, to better reflect the risk related to these loans, the Credit Union changed its historical time line to develop its charge-off ratios from 36 months to 12 months. This had a nominal impact on the ALL balance and provision for loan losses expense.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
NOTE 4: PROPERTY AND EQUIPMENT

A summary of the Credit Union's property and equipment is as follows:

	As of December 31,	
	2012	2011
Land	\$3,468,245	\$3,468,245
Land purchase commitment	1,103,600	—
Buildings	23,766,023	23,738,378
Furniture and equipment	11,423,232	11,238,472
Construction in progress	910,323	16,458
Projects in progress	191,972	68,368
	40,863,395	38,529,921
Less accumulated depreciation	(20,550,061)	(19,396,196)
	\$20,313,334	\$19,133,725

***NOTE 5: MEMBERS' SHARE
AND SAVINGS ACCOUNTS***

Members' share and savings accounts are summarized as follows:

	As of December 31,	
	2012	2011
Share draft accounts	\$90,200,925	\$83,490,031
Share accounts	332,365,432	302,269,785
Money market accounts	94,135,011	98,468,577
Individual retirement accounts	21,176,845	22,140,503
Certificates of deposit and IRA certificates	204,481,328	219,256,727
	\$742,359,541	\$725,625,623

The aggregate balance of members' time deposit accounts in denominations of \$100,000 and over was approximately \$52,729,000 and \$53,683,000 as of December 31, 2012 and 2011, respectively.

Scheduled maturities of share and IRA certificates are as follows:

	As of December 31, 2012
Within 1 year	\$128,998,564
1 to 2 years	38,957,531
2 to 3 years	22,242,264
3 to 4 years	9,585,128
4 to 5 years	4,051,784
Thereafter	646,057
	\$204,481,328

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 5: (continued)

SHARE INSURANCE

Members' share accounts are insured by the NCUSIF to a maximum of \$250,000 for each member. Individual Retirement Accounts are separately insured to a maximum of \$250,000. The Credit Union also maintains excess share insurance through Excess Share Insurance Corporation which provides an additional amount of share insurance of \$100,000 per account, subject to a \$15,000,000 coverage limit. Additionally, non-interest bearing share accounts are fully insured by the NCUSIF until December 31, 2012.

NOTE 6: EMPLOYEE BENEFITS

PENSION PLAN

The Credit Union participates in a state sponsored defined benefit pension plan covering substantially all of its employees. For the years ended December 31, 2012 and 2011, contributions and cost were determined as a percentage of each covered employee's paid earnings and totaled approximately \$2,470,000 and \$2,280,000 for the years ended December 31, 2012 and 2011, respectively.

**NOTE 7: COMMITMENTS AND
CONTINGENT LIABILITIES**

LEASE COMMITMENTS

The Credit Union had outstanding commitments under operating leases for ATM equipment and servicing as of December 31, 2012. The minimum noncancellable lease obligations approximate the following as of December 31, 2012:

Year ending December 31,	Amount
2013	\$146,000
2014	59,000
2015	18,000
2016	5,000
2017	3,000
Thereafter	<div style="border-top: 1px solid black; border-bottom: 3px double black; display: inline-block; padding: 2px 5px;">\$231,000</div>

Rental expense under operating leases was approximately \$255,000 and \$308,000 for the years ended December 31, 2012 and 2011, respectively.

LINES OF CREDIT

As of December 31, 2012, the Credit Union maintained an unused line of credit with KyCorp. The KyCorp agreement requires the pledging of all assets as security for obligations under this line-of-credit agreement. The unused line of credit under this agreement was \$10,000,000 as of December 31, 2012.

<p style="text-align: center;">COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS</p>

Note 7: (continued)

As a member of the FHLB, the Credit Union had access to a pre-approved secured line of credit with the capacity to borrow up to a certain percentage of the value of its eligible 1-4 family first mortgage loans, as defined in the FHLB Statement of Credit Policy. The aggregate unused line of credit under this agreement was approximately \$44,835,000 as of December 31, 2012.

***NOTE 8: OFF-BALANCE-SHEET RISK
AND CONCENTRATIONS OF CREDIT RISK***

OFF-BALANCE SHEET RISK:

The Credit Union is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statements of financial condition. Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses.

Since many of the commitments may expire without being fully drawn upon, the total commitment amounts do not necessarily represent future cash requirements. As of December 31, 2012, the total unfunded commitment under such lines of credit was approximately \$229,092,000. The Credit Union evaluates each member's creditworthiness on a case-by-case basis. The amount of collateral obtained, if any, is based on management's credit evaluation of the member.

CONCENTRATIONS OF CREDIT RISK:

The Credit Union may be exposed to credit risk from a regional economic standpoint, since a significant concentration of its borrowers work or reside in the state of Kentucky. However, the loan portfolio is well diversified and the Credit Union does not have any significant concentrations of credit risk.

NOTE 9: REGULATORY CAPITAL

The Credit Union is subject to various regulatory capital requirements administered by the NCUA. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Credit Union's financial statements. Under capital adequacy regulations and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital regulations that involve quantitative measures of the Credit Union's assets, liabilities, and certain off-balance-sheet items as calculated under generally accepted accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

COMMONWEALTH CREDIT UNION NOTES TO THE FINANCIAL STATEMENTS
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Note 9: (continued)

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios (set forth in the table below) of net worth (as defined in NCUA Regulations) to total assets (as defined in NCUA Regulations). Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not the Credit Union will be considered "complex" under the regulatory framework. The Credit Union's RBNWR as of December 31, 2012 and 2011 was 6.05% and 5.05% respectively. The minimum ratio to be considered complex under the regulatory framework is 6.00%. Management believes, as of December 31, 2012 and 2011, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2012, the most recent call reporting period, the NCUA categorized the Credit Union as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized" the Credit Union must maintain a minimum net worth ratio of 7.00% of total assets. There are no conditions or events since that notification that management believes have changed the Credit Union's category.

The Credit Union's actual and required net worth amounts and ratios are as follows:

	As of December 31, 2012		As of December 31, 2011	
	Amount	Ratio/ Requirement	Amount	Ratio/ Requirement
Actual net worth	\$174,935,454	18.85%	\$161,705,920	18.03%
Amount needed to be classified as "well capitalized"	\$64,962,201	7.00%	\$62,790,350	7.00%
Amount needed to meet RBNWR	\$56,145,902	6.05%	\$—	—
Amount needed to be classified as "adequately capitalized"	\$55,681,886	6.00%	\$53,820,300	6.00%

Because the RBNWR is less than the net worth ratio, the Credit Union retains its original category of well capitalized. Furthermore in performing its calculation of total assets the Credit Union used the quarter end option, as permitted by regulation.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
**NOTE 10: FAIR VALUES OF FINANCIAL
INSTRUMENTS**

The Fair Value Measurements and Disclosures Topic of the FASB ASC provides a framework for measuring fair value that requires an entity to derive fair value from the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date within its principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. To increase consistency and comparability in fair value measurements and related disclosures, a three-level hierarchy prioritizes the inputs to valuation techniques used to measure fair value with the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1), inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly (Level 2), and the lowest priority to unobservable inputs (Level 3).

The methodologies and associated inputs used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While the Credit Union believes its valuation methods and associated inputs are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

The estimated fair values presented below are for disclosure purposes only and have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of amounts that could be realized in a market exchange. The use of different assumptions and estimation methodologies may have a material effect on the estimated fair value amounts. The following tables set forth by level, within the fair value hierarchy, the Credit Union's financial instruments at fair value:

Assets at Fair Value as of December 31, 2012				
	Level 1	Level 2	Level 3	Total
Assets:				
Collateralized mortgage obligations	\$—	\$131,402,162	\$—	\$131,402,162
Federal agency securities	—	124,002,910	—	124,002,910
Mortgage-backed securities	—	22,761,619	—	22,761,619
Corporate bonds	—	9,057,198	—	9,057,198
	\$—	\$287,223,889	\$—	\$287,223,889

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS

Note 10: (continued)

	Assets at Fair Value as of December 31, 2011			
	Level 1	Level 2	Level 3	Total
Assets:				
Federal agency securities	\$—	\$201,627,115	\$—	\$201,627,115
Mortgage-backed securities	—	70,638,399	—	70,638,399
	<u>\$—</u>	<u>\$272,265,514</u>	<u>\$—</u>	<u>\$272,265,514</u>

The estimated fair values of other financial instruments have been determined using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of amounts that could be realized in a market exchange. The use of different assumptions and estimation methodologies may have a material effect on the estimated fair value amounts.

The following methods and assumptions were used to estimate fair value of each of the financial instruments for which it was practicable to estimate.

CASH AND CASH EQUIVALENTS/NON-NEGOTIABLE CERTIFICATES OF DEPOSIT

The carrying amount is a reasonable estimation of fair value due to the short-term nature of these instruments.

INVESTMENTS

Estimated fair values for investments are obtained from observable market prices for similar instruments. The fair values for available-for-sale securities take into account recent market activity as well as other market observable data such as interest rate, spread and prepayment information.

LOANS TO MEMBERS

The estimated fair value of variable-rate loans is the current carrying amount. The fair value of fixed-rate loans was estimated by discounting the estimated cash flows using the current rate at which similar loans would be issued.

ACCRUED INCOME RECEIVABLE

The carrying amount is a reasonable estimation of fair value.

MEMBERS' SHARE AND SAVINGS ACCOUNTS

The estimated fair value of demand deposit accounts (regular share, share draft, and money market accounts, etc.) is the carrying amount. The fair value of fixed-rate certificates was estimated by discounting the estimated cash flows using the current rate at which similar certificates would be issued.

COMMONWEALTH CREDIT UNION
NOTES TO THE FINANCIAL STATEMENTS
Note 10: (continued)**COMMITMENTS TO EXTEND CREDIT**

The fair value of commitments to extend credit is equivalent to the amount of credit extended since the Credit Union does not charge fees to enter into these commitments and the commitments are not stated at fixed rates.

The carrying value and estimated fair value of the Credit Union's financial instruments are as follows:

	As of December 31, 2012		As of December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<i>Financial assets:</i>				
Cash and cash equivalents	\$47,686,053	\$47,686,053	\$36,710,383	\$36,710,383
Non-negotiable certificates of deposit	\$5,416,000	\$5,416,000	\$11,193,853	\$11,193,853
<i>Investments:</i>				
Available-for-sale	\$287,223,889	\$287,223,889	\$272,265,514	\$272,265,514
Held-to-maturity	\$—	\$—	\$264,623	\$232,155
Loans to members, net	\$550,349,290	\$553,172,000	\$538,537,221	\$549,077,131
Accrued interest receivable	\$2,905,005	\$2,905,005	\$2,718,699	\$2,718,699
<i>Financial liabilities:</i>				
Members' share and savings accounts	\$742,359,541	\$741,857,000	\$725,625,623	\$729,820,875
<i>Unrecognized financial instruments:</i>				
Commitments to extend credit	\$—	\$229,092,000	\$—	\$223,323,000

NOTE 11: INDUSTRY EVENTS

In January 2009, the NCUA informed federally-insured credit unions that it was taking actions to enhance and support the corporate credit union system as well as the NCUSIF. During June 2009, legislation was created to establish a Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund) to absorb the corporate stabilization costs by borrowing money from the U.S. Treasury. During September 2010, the NCUA received approval from the U.S. Treasury to extend the life of the Stabilization Fund to June 2021. The funds borrowed from the U.S. Treasury will be repaid from assessments authorized by the NCUA Board. The NCUA Board has levied assessments during 2009, 2010, 2011 and 2012 to repay borrowed funds to the U.S. Treasury. It is anticipated that the NCUA Board will be making annual assessments over the next several years to cover costs associated with the corporate credit union system.

★★★★★★

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March 18, 2013

To the Supervisory Committee, Board of Directors
and Management of Commonwealth Credit Union

This letter is intended to inform those charged with governance about significant matters related to the conduct of the annual audit of Commonwealth Credit Union (the Credit Union), so they can appropriately discharge their oversight responsibility, and so we comply with our professional responsibilities to the Supervisory Committee.

In addition to our report on the Credit Union's financial statements, we have provided our "Report to the Supervisory Committee" which is intended to help interpret the Credit Union's financial statements for the year ended December 31, 2012, and to assist the Supervisory Committee, Board of Directors, and management in developing policies and procedures to enhance internal controls. The following summarizes various matters that must be communicated to you under auditing standards generally accepted in the United States of America.

In planning and performing our audit of the Credit Union's financial statements as of and for the year ended December 31, 2012, in accordance with auditing standards generally accepted in the United States of America, we considered the Credit Union's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Credit Union's internal control. Accordingly, we do not express an opinion on the effectiveness of the Credit Union's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

Control Deficiencies

A deficiency (**D**) in internal control exists when the design or operation of the control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A material weakness (**MW**) is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected in a timely basis.

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To the Supervisory Committee, Board of Directors
and Management of Commonwealth Credit Union
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A significant deficiency (SD) is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The comments in our "Report to the Supervisory Committee" are matters that represent opportunities for improving or enhancing the design or operation of the internal control structure, or other matters which we believe to be of value to the Credit Union.

Our Responsibility under U.S. Generally Accepted Auditing Standards

As stated in our engagement letter dated June 29, 2010, our responsibility, as described by professional standards, is to express an opinion about whether the financial statements prepared by management with your oversight are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit of the financial statements does not relieve you or management of your responsibilities.

Our audit of the Credit Union's financial statements for the year ended December 31, 2012, was conducted in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error, fraudulent financial reporting, or misappropriation of assets. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Accordingly, the audit was designed to obtain reasonable, rather than absolute, assurance about the financial statements. We believe that our audit accomplished that objective.

Planned Scope and Timing of the Audit

We performed the audit according to the planned scope and timing previously communicated to you in an email regarding planning matters on October 15, 2012.

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the Credit Union are described in the notes to the financial statements. We noted no transactions entered into by the Credit Union during the year ended December 31, 2012, for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transactions occurred.

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To the Supervisory Committee, Board of Directors
and Management of Commonwealth Credit Union

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Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. We believe that the following represent particularly sensitive account estimates:

Allowance for Loan Losses: The allowance is an amount management believes will be adequate to absorb estimated losses on existing loans. Management's accounting policies used to estimate the adequacy of the allowance account are described in the notes to the financial statements. The estimation process can be subjectively increased or decreased based on management's evaluation of the economy, business trends, and other factors. We have performed tests of the allowance for loan losses account as of the audit date to satisfy ourselves as to its reasonableness in relation to the financial statements taken as a whole.

Investment Securities: Securities classified as available-for-sale are carried at fair value. Unrealized gains or losses are reported as a separate component of accumulated other comprehensive income. Estimated fair values for investments are obtained from quoted market prices where available. Where quoted market prices are not available, estimated fair values are based on quoted market prices of comparable instruments.

Fair Value of Other Financial Instruments: The estimated fair value amounts have been determined by the Credit Union using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented in the financial statements are not necessarily indicative of the amounts the Credit Union could realize in a market exchange. The use of different assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Audit Adjustments

For purposes of this letter, professional standards define an audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. An audit adjustment may or may not indicate matters that could have a significant effect on the Credit Union's financial reporting process (that is, cause future financial statements to be materially misstated). There were no entries recorded to the original trial balance presented to us at the beginning of our audit.

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To the Supervisory Committee, Board of Directors
and Management of Commonwealth Credit Union
Page 4

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditors' report. We encountered no disagreements with management over the application of significant accounting principles, the basis for management's judgments on any significant matters, the scope of the audit, or significant disclosures to be included in the financial statements.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated March 18, 2013.

Consultation with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a *second opinion* on certain situations. If a consultation involves application of an accounting principle to the Credit Union's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Issues Discussed Prior to Retention of Independent Auditors

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Credit Union's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Difficulties Encountered in Performing the Audit

We did not encounter any difficulties in dealing with management relating to the performance of the audit.

To the Supervisory Committee, Board of Directors
and Management of Commonwealth Credit Union
Page 5

Closing

This letter is intended solely for the use of the Supervisory Committee, Board of Directors, and management of Commonwealth Credit Union and is not intended to be and should not be used by anyone other than these specified parties. We appreciate this opportunity to be of service to Commonwealth Credit Union and wish to express our appreciation for the cooperation and assistance we received from management, Internal Audit and Credit Union staff during our audit. If we can be of any further assistance to the Supervisory Committee or if there are any questions regarding the contents of this report, please do not hesitate to contact us.

Orth, Chakler, Murnane & Co.

Orth, Chakler, Murnane & Company
Certified Public Accountants

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Commonwealth Credit Union
Report to the Supervisory Committee
December 31, 2012

Financial Overview:

During the year ended December 31, 2012, total assets and members' deposits increased by approximately \$31,026,000 (3.5%) and \$16,734,000 (2.3%), respectively, while outstanding loans to members increased by approximately \$11,648,000 (2.1%). As a result of the changes noted above, the Credit Union's loan to share ratio remained at approximately 75% as of December 31, 2012 and 2011. The peer group average for this ratio was approximately 70%.

The Credit Union reported net income of approximately \$13,230,000 and \$9,297,000 during the years ended December 31, 2012 and 2011, respectively. This equated to a return on average assets ratio of approximately 1.45% and 1.05% for the years ended December 31, 2012 and 2011, respectively. The following table compares the Credit Union's profitability during the last two years:

Components of net income	2012	2011	Impact on ROA
Interest income/average assets	4.16	4.26	(10)
Interest expense/average assets	(0.44)	(0.68)	24
Net interest margin	3.72	3.58	14
Provision for loan losses/average assets	(0.36)	(0.41)	5
Non-interest expenses/average assets	(3.15)	(3.26)	11
Non-interest income/average assets	1.32	1.34	(2)
Corporate credit union stabilization fund assessments/average assets	(0.08)	(0.20)	12
Return on average assets (ROA)	1.45	1.05	40

As noted above, the Credit Union's return on average assets ratio increased by 40 basis points compared to the year ended December 31, 2011. Each component of the Credit Union's return on average assets ratio is discussed below:

Net interest margin/average assets:

As the low interest rate environment continued throughout 2012, the Credit Union's interest income to average assets ratio decreased by 10 basis points from 4.26% to 4.16% during the years ended December 31, 2011 and 2012, respectively. However, during the same period, the Credit Union's interest expense to average asset ratio decreased by 24 basis points from 0.68% during the year ended December 31, 2011, to 0.44% during the year ended December 31, 2012. As a result, the Credit Union's net interest margin improved by 14 basis points from 3.58% to 3.72% during the years ended December 31, 2011 and 2012, respectively. This is well above the NCUA peer group average of approximately 2.93%.

- Internal Use Only -

***Commonwealth Credit Union
Report to the Supervisory Committee
December 31, 2012***

Provision for loan losses/average assets:

The Credit Union's provision for loan losses expense decreased by approximately \$404,000 (11%) during the year ended December 31, 2012, which caused the provision for loan losses to average assets ratio to decrease by 5 basis points from 0.41% to 0.36% during the years ended December 31, 2011 and 2012, respectively. The decrease in the provision for loan losses expense was attributed to a reduction in the estimate of the allowance for loan losses in both the real estate and commercial loan participation portfolios.

Non-interest expenses/average assets:

The Credit Union's non-interest expenses decreased by approximately \$267,000 (1%) during the year ended December 31, 2012. This, combined with growth in average total assets during the same period, caused the Credit Union's non-interest expense to average assets ratio to decrease by 11 basis points from 3.26% to 3.15% during the years ended December 31, 2011 and 2012. The most significant changes were experienced in employee compensation/benefits which decreased by approximately \$1,100,000, while office operating expenses increased by approximately \$650,000 during the year ended December 31, 2012.

Non-interest income/average assets:

The Credit Union's non-interest income increased by approximately \$425,000 (4%) during the year ended December 31, 2012. However, due to the growth in average total assets during the same period, the Credit Union's non-interest income to average assets ratio decreased by 2 basis points from 1.34% to 1.32% for the years ended December 31, 2011 and 2012, respectively.

Corporate Credit Union Stabilization Fund Assessments/average assets:

During September 2011, the NCUA Board assessed a 25 basis point assessments based on the Credit Union's insured shares as of June 30, 2011. This cost approximated \$1,767,000 and resulted in a 20 basis point reduction to the Credit Union's return on average assets ratio for the year ended December 31, 2011. During July 2012, the NCUA Board assessed a 9.5 basis point assessment based on the Credit Union's insured shares as of June 30, 2012. This cost approximated \$705,000 and resulted in an 8 basis point reduction to the Credit Union's return on average assets ratio for the year ended December 31, 2012.

Net worth ratio:

The net worth ratio measures the Credit Union's financial strength and it is calculated by dividing the balance of retained earnings (e.g. regular reserve and undivided) by the outstanding balance of total assets. The net worth ratio changes as a result of the Credit Union's profitability level and total asset growth or decline. As a result of controlling total asset growth and operating with a return on average assets ratio of 1.45% during the year ended December 31, 2012, the Credit Union's net worth ratio increased by 82 basis points from 18.03% to 18.85% as of December 31, 2011 and 2012, respectively. This ratio is indicative of a very strong financial position and far exceeds the 7.0% level to be classified as "well capitalized" under NCUA Regulations. The NCUA peer group average for this ratio was approximately 10.22%. It should be noted that this ratio will be negatively impacted in 2014 when the accounting rules change for the Credit Union's pension plan.

***Commonwealth Credit Union
Report to the Supervisory Committee
December 31, 2012***

Accounting Function:

As external auditors, our primary responsibility is to attest to the accuracy of the Credit Union's financial data and to ensure compliance with accounting principles generally accepted in the United States of America (GAAP/USA). To accomplish this, we reviewed the appropriate documentation to support the financial statement balances, reviewed the quality of the subsidiary accounting records, assessed the reasonableness of significant estimates made by management, and evaluated the overall financial statement presentation and disclosures. As a result of our audit, we identified the following observations that relate to the Credit Union's accounting function:

1. We reviewed the Credit Union's allowance for loan losses analysis and noted the following:

A. **(D)** The Credit Union does not include recoveries when developing the net loan loss ratios used to estimate the loan loss reserves for each loan pool. This has led to an overstatement of the allowance account by approximately \$925,000 as of December 31, 2012.

We recommend that management include recoveries when determining the loan loss ratios used to estimate the allowance for loan losses.

B. **(D)** The Credit Union does not perform a qualitative or environmental analysis that considers leading indicators that might suggest loan losses will be greater than or less than what the historical loan loss ratios are indicating. As of December 31, 2012, the Credit Union's delinquent loans in the consumer portfolio have increased substantially as compared to the prior year. This may indicate that the Credit Union should have a greater amount in the allowance for loan losses than the amounts that were estimated using the historical loan loss ratios as of December 31, 2012. Based on the increase in delinquent loans, we estimated an understatement of the allowance for loan losses of approximately \$950,000 as of December 31, 2012.

We recommend that management develop a qualitative and environmental analysis to use for evaluating factors such as unemployment, real estate values, and trends in delinquency. The qualitative and environmental analysis should be used to adjust the estimate of incurred losses to reflect changes in the leading indicators that affect the performance of the Credit Union's loan portfolio.

2. **(D)** The Credit Union pays auto dealers a commission on loans that are purchased. This fee is capitalized and amortized over the average life of the loan. During our audit, we noted that the Credit Union reconciles the payments made to dealers to the list of loans granted by the indirect lending department. In addition, the Credit Union ensures that the amortization of deferred costs recorded in the subsidiary records agrees to the general ledger account; however, there is no reconciliation of the subsidiary ledger to the balance sheet general ledger account. As a result, errors or unauthorized entries made to the balance sheet account could go undetected. As of December 31, 2012, the subsidiary ledger did not agree to the general ledger account by approximately \$328,000.

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***Commonwealth Credit Union
Report to the Supervisory Committee
December 31, 2012***

We reviewed the Credit Union's spreadsheet used to account for the indirect dealer fees with management and noted that the spreadsheet likely has caused the error and that the general ledger balance appeared to be correctly stated.

We recommend that a review be performed of the spreadsheet used to account for the indirect dealer fees. Once the spreadsheet is corrected, we recommend the indirect dealer fees spreadsheet be reconciled to the general ledger account on a monthly basis.

Lending Function:

The Credit Union's outstanding loan portfolio increased by approximately \$11,648,000 (2.1%) during the year ended December 31, 2012, as a result of increases in real estate loans of approximately \$9,121,000 (3.7%) and consumer loans of approximately \$8,022,000 (2.8%%) between years. These increases were offset by a decrease in commercial participation loans of approximately \$5,555,000 (31.9%) during the year ended December 31, 2012. As of December 31, 2012, approximately 52.3% of the Credit Union's loan portfolio were consumer loans, approximately 45.6% were real estate loans, and approximately 2.1% were commercial loans.

In conjunction with our loan audit, we reviewed a sample of the new loans granted to the members and Credit Union employees during the year ended December 31, 2012. In addition, we reviewed all of the new loans granted to the Credit Union's officials during this same period. Each loan in our sample was specifically reviewed for compliance with the Credit Union's written loan policy. Loan file documentation was reviewed for the appropriate income/employment verification, substantiation of an ability to repay the loan, the completeness of the required documentation, and the accuracy of the information within the computer system.

We also reviewed the following exception reports for unusual items:

- ◆ Share secured loans and related pledged balances.
- ◆ Loans paid ahead greater than 180 days.
- ◆ Loans with accrued interest greater than \$500.
- ◆ Loans with interest rates less than 3% or greater than 18%.

Overall, we found the loan files to be well organized and maintaining appropriate documentation to support the Credit Union's lending decision as required by the written loan policy. However, we discussed the following items with management to help improve internal controls in the lending area:

Commonwealth Credit Union
Report to the Supervisory Committee
December 31, 2012

1. (D) During our audit, we noted the Credit Union was not reviewing a report of accrued interest on loans greater than the payment amount for unusual characteristics. Reviewing this report can assist management in identifying the following:

- Input errors
- Unauthorized advancement of payment due dates
- Misapplication of principal and interest payments

We recommend that management periodically generate and review a report of accrued interest on loans greater than the payment amount to identify unusual loan characteristics in a timely manner.

2. (D) During our review of loan controls, we noted the Credit Union was not reviewing a report of loans with unusually low interest rates. We reviewed such a report and discovered one loan with an approved interest rate of 5.79% that was modified in the system to 0.003%. This appears to be an isolated incident that was caused when recording an adjustment to the member's due date.

We recommend that a review of unusual interest rates be included as part of the file maintenance review process.

★★★★★★

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Independent Auditor's Report

To the Board of Directors and Supervisory Committee
of **Commonwealth Credit Union**

Report on the Financial Statements

We have audited the accompanying financial statements of Commonwealth Credit Union, which comprise the statement of financial condition as of December 31, 2013, and the related statements of earnings, comprehensive income, members' equity and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

DoerenMayhew

Auditor's Responsibility - Continued

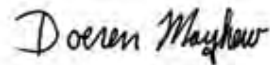
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Credit Union as of December 31, 2013, and the results of its operations and its cash flows for the year then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matter

The financial statements of Commonwealth Credit Union for the year ended December 31, 2012, were audited by other auditors whose report dated March 18, 2013, expressed an unqualified opinion.



DOEREN MAYHEW

April 8, 2014
Troy, Michigan

COMMONWEALTH CREDIT UNION**STATEMENTS OF FINANCIAL CONDITION****ASSETS**

	December 31,	
	2013	2012
Cash and cash equivalents	\$ 24,899,993	\$ 47,386,051
Non-negotiable certificates of deposit	5,416,000	5,416,000
Investment securities (note 2)		
Available-for-sale	286,144,391	287,223,892
Loans to members, net of allowance for loan losses (note 3)	585,537,675	550,349,292
Accrued interest receivable	2,753,674	2,905,005
Property and equipment (note 4)	24,111,414	19,209,734
NCUSIF deposit (note 1)	7,559,122	7,567,323
Federal Home Loan Bank participation stock (note 1)	1,711,300	1,711,300
Perpetual contributed capital (note 1)	691,987	691,987
Other real estate owned (note 1)	597,453	884,969
Other assets	4,554,327	4,685,888
Total assets	<u>\$ 943,977,336</u>	<u>\$ 928,031,441</u>

LIABILITIES AND MEMBERS' EQUITY**Liabilities**

Members' shares and savings accounts (note 6)	\$ 756,199,846	\$ 742,359,542
Accounts payable	5,758,074	5,414,774
Other accrued liabilities	4,923,800	4,336,796

Total liabilities	766,881,720	752,111,112
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Commitments and Contingent Liabilities (note 9)

Members' Equity - Substantially Restricted (note 7)	<u>177,095,616</u>	<u>175,920,329</u>
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Total liabilities and members' equity	<u>\$ 943,977,336</u>	<u>\$ 928,031,441</u>
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See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

STATEMENTS OF EARNINGS

	Year Ended December 31,	
	2013	2012
Interest Income		
Loans receivable	\$ 34,484,516	\$ 34,960,284
Investment securities	3,966,965	2,987,384
Total interest income	38,451,481	37,947,668
Interest Expense		
Interest and dividends on members' shares and savings accounts	3,211,497	3,998,836
Interest on borrowed funds	2	324
Total interest expense	3,211,499	3,999,160
Net interest income	35,239,982	33,948,508
Provision For Loan Losses	6,079,412	3,280,671
Net interest income after provision for loan losses	29,160,570	30,667,837
Non-Interest Income		
Fees and charges	12,298,905	12,004,187
Non-Interest Expenses		
Compensation and benefits	18,391,014	17,291,092
Office operations	8,623,759	7,950,829
Occupancy	1,637,845	1,492,984
Operating expenses	2,857,151	2,002,939
TCCUSF assessments (note 1)	605,705	704,646
Total non-interest expenses	32,115,474	29,442,490
Net Earnings	<u>\$ 9,344,001</u>	<u>\$ 13,229,534</u>

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION
STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,	
	<u>2013</u>	<u>2012</u>
Net Earnings	\$ 9,344,001	\$ 13,229,534
Other Comprehensive Income (Loss)		
Net changes in unrealized gains on investments classified as available-for-sale	<u>(8,168,714)</u>	<u>180,637</u>
Comprehensive Income	<u>\$ 1,175,287</u>	<u>\$ 13,410,171</u>

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

STATEMENTS OF MEMBERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

	Appropriated Statutory	Undivided Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
Members' Equity - January 1, 2012	\$ 20,827,421	\$ 140,878,499	\$ 804,238	\$ 162,510,158
Comprehensive Income				
Net earnings	-	13,229,534	-	13,229,534
Net change in unrealized gains on securities	-	-	180,637	180,637
Comprehensive income	-	13,229,534	180,637	13,410,171
Members' Equity - December 31, 2012	20,827,421	154,108,033	984,875	175,920,329
Comprehensive Income (Loss)				
Net earnings	-	9,344,001	-	9,344,001
Net change in unrealized gains on securities	-	-	(8,168,714)	(8,168,714)
Comprehensive income (loss)	-	9,344,001	(8,168,714)	1,175,287
Members' Equity - December 31, 2013 (note 7)	<u>\$ 20,827,421</u>	<u>\$ 163,452,034</u>	<u>\$ (7,183,839)</u>	<u>\$ 177,095,616</u>

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

STATEMENTS OF CASH FLOWS

	Year Ended December 31,	
	2013	2012
Cash Flows From Operating Activities:		
Net earnings	\$ 9,344,001	\$ 13,229,534
Adjustments:		
Depreciation	1,473,368	1,544,372
Provision for loan losses	6,079,412	3,280,671
Loss (gain) on sale of investments	(8,910)	249,454
Amortization of deferred loan origination fees	828,582	736,386
Net amortization/accretion of premiums/discounts on investments	(524,993)	2,687,200
Losses on sale of other real estate owned	52,476	72,591
Recoveries on charged-off loans	957,974	926,397
Changes in assets and liabilities:		
Decrease (increase) in accrued interest receivable	151,331	(186,306)
Decrease in prepaids and other assets	131,561	792,437
Increase in accounts payable and other	343,300	1,261,817
Increase (decrease) in accrued liabilities	587,004	(154,152)
Total adjustments	10,071,105	11,210,867
Net cash provided from operating activities	19,415,106	24,440,401

See accompanying notes to financial statements.

COMMONWEALTH CREDIT UNION

STATEMENTS OF CASH FLOWS

	Year Ended December 31,	
	2013	2012
Cash Flows From Investing Activities:		
Increase in loans to members (net)	\$ (44,352,485)	\$ (17,146,434)
Decrease in non-negotiable certificates of deposit (net)	-	5,777,853
Proceeds from maturities of investment securities		
Held-to-maturity	-	230,665
Available-for-sale	108,350,756	329,120,097
Purchases of investment securities		
Available-for-sale	(114,946,377)	(346,834,489)
Decrease (increase) in share insurance deposit, net of impairment	8,201	(351,076)
Acquisition of property and equipment	(6,375,048)	(1,620,382)
Proceeds from sale of other real estate owned	1,573,485	329,536
Net cash used in investing activities	(55,741,468)	(30,494,230)
Cash Flows From Financing Activities:		
Increase in members' shares and savings accounts (net)	13,840,304	16,733,919
Net Increase (Decrease) in Cash and Cash Equivalents	(22,486,058)	10,680,090
Cash and Cash Equivalents - Beginning	47,386,051	36,705,961
Cash and Cash Equivalents - Ending	\$ 24,899,993	\$ 47,386,051

Supplemental Information

Non-cash increase in other real estate owned	\$ 1,298,133	\$ 380,908
Interest and dividends paid	\$ 3,211,499	\$ 3,999,160

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies

Nature of Business

Commonwealth Credit Union is a cooperative association organized in accordance with Chapter 290 of the Kentucky State Chartered Credit Union Law. Commonwealth Credit Union's operations are principally related to holding deposits for and making loans to employees of the Commonwealth of Kentucky and their families.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The statements of cash flows classify changes in cash or cash equivalents (short-term, highly liquid investments readily convertible into cash with an original maturity of three months or less) according to operating, investing or financing activities. Financial instruments which potentially subject the Credit Union to concentrations of credit risk consist principally of cash and temporary cash investments. At times, cash balances held at financial institutions were in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits. The Credit Union places its temporary cash investments with high-credit, quality financial institutions and, by policy, limits the amount of credit exposure to any one financial institution. The Credit Union believes no significant concentration of credit risk exists with respect to these cash investments.

Investment Securities

The Credit Union's investments in securities for the years ended December 31, 2013 and 2012 are classified and accounted for as follows:

Available-for-Sale Securities

Securities available-for-sale consists of securities not otherwise classified as trading securities or securities to be held-to-maturity and are recorded at fair value, with unrealized gains and losses excluded from earnings and reported in accumulated other comprehensive income/(loss).

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies - Continued

Investment Securities - Continued

Gains and losses on sales of securities available-for-sale are determined using the specific-identification method.

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are other-than-temporary are reflected as realized losses. In estimating other-than-temporary impairment, management considers: (1) the Credit Union's intent to sell the debt security prior to recovery and, (2) whether it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. If the Credit Union does not intend to sell a security, and it is more likely than not, the Credit Union will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in accumulated other comprehensive income/(loss).

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

NCUSIF Deposit and Insurance Premium

The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with the National Credit Union Association (NCUA) regulations, which require the maintenance of a deposit by each insured credit union in an amount equal to one percent of its insured shares. The deposit would be refunded to the credit union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board. No dividends were paid for the years ended December 31, 2013 and 2012. The NCUSIF deposit is required to be reviewed for impairment, including consideration of the refundability of the deposit.

The NCUA assessed all federally insured credit unions premiums of 0.08% for 2013 and 0.095% for 2012 of insured shares for the repayment of the funds borrowed from the Treasury Department by the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). The Credit Union paid the assessments related to the TCCUSF of approximately \$606,000 and \$705,000 during the years ended December 31, 2013 and 2012, respectively.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies - Continued

Loans to Members

Loans that the Credit Union has the intent and ability to hold for the foreseeable future are stated at unpaid principal balances, less an allowance for loan losses and net deferred loan origination fees and discounts. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding.

The accrual of interest on loans is discontinued on a loan when a loan exceeds 90 days delinquent or when management believes, after considering economics, business conditions, and collection efforts that the borrowers' financial condition is such that collection of interest is doubtful.

Certain direct loan origination costs are deferred and recognized as an adjustment to interest income using the straight-line method over the contractual life of the loans. The straight-line method, which is not in accordance with generally accepted accounting principles, is not materially different from the interest method, which is required under generally accepted accounting principles.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies - Continued

Allowance for Loan Losses - Continued

The Credit Union's allowance for loan losses is that amount considered adequate to absorb probable losses in the portfolio based on management's evaluations of the size and current risk characteristics of the loan portfolio. Such evaluations consider prior loss experience, the risk rating distribution of the portfolios, the impact of current internal and external influences on credit loss and the levels of non-performing loans. Specific allowances for loan losses are established for large impaired loans on an individual basis as required by generally accepted accounting principles. The specific allowances established for these loans is based on a thorough analysis of the most probable source of repayment, including the present value of the loan's expected future cash flow, the loan's estimated market value, or the estimated fair value of the underlying collateral. General allowances are established for loans that can be grouped into pools based on similar characteristics as described in generally accepted accounting principles. In this process, general allowance factors are based on an analysis of historical charge-off experience and expected losses given default derived from the Credit Union's internal risk rating process. These factors are developed and applied to the portfolio in terms of loan type. The qualitative factors associated with the allowances are subjective and require a high degree of management judgment. These factors include the credit quality statistics, recent economic uncertainty, losses incurred from recent events and lagging data.

The following portfolio segments have been identified: consumer, real estate, and commercial. The Credit Union divides these segments into classes based on the associated risks within those segments. Consumer loans are divided into the following classes: Vehicle, Unsecured, and Other Secured. Member owned real estate loans are divided into the following classes: First and Second Mortgages and Home Equity Loans. Commercial loans are Business Partners (BP), Inc, participation loans primarily secured by commercial real estate.

A loan is impaired when full payment under the loan terms is not expected. Real estate and commercial loans are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Real estate loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are classified as impaired. Troubled debt restructurings are measured at the present value of estimated future cash flows using the loans effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies - Continued

Assets Acquired in Liquidation of Loans

Assets acquired in liquidation of loans represent collateral used to secure members' loans that have been acquired by the Credit Union in an effort to settle the members' loan and are recorded at the lower of cost or market less costs of liquidation.

Upon acquisition, the Credit Union determines fair value of the collateral and any losses are charged-off through the allowance for loan losses. The Credit Union continues to review these properties for subsequent impairment and any subsequent declines in fair value are recorded through current period earnings.

Income Taxes

The Credit Union is exempt, by statute (IRC Section 501(c)14), from Federal and income taxes and Kentucky Business tax.

The Credit Union is a state-chartered credit union described in Internal Revenue Code ("IRC") Section 501(c)(14). As such, the Credit Union is exempt from federal taxation of income derived from the performance of activities that are in furtherance of its exempt purposes. However, IRC Section 511 imposes a tax on the unrelated business income (as defined in Section 512) derived by state-chartered credit unions. Many states have similar laws. The specific application of Section 512 to the various activities conducted by state-chartered credit unions has been an issue for many years. In 2007, the Internal Revenue Service ("IRS") issued a series of Technical Advice Memoranda ("TAM") to a number of state-chartered credit unions located throughout the country. In these TAMs, the IRS ruled certain products and services to be subject to taxation as unrelated business income. In light of the TAMs, the Credit Union has assessed its activities and any potential federal or state income tax liability. In the opinion of management, any liability arising from federal or state taxation of activities deemed to be unrelated to its exempt purpose is not expected to have a material effect on the Credit Union's financial condition or results of operation.

Members' Shares and Savings Accounts

Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Interest on members' shares and savings accounts is based on available earnings at the end of an interest period and is not guaranteed by the Credit Union. Interest rates on members' shares accounts are set by the Board of Directors, based on an evaluation of current and future market conditions.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies - Continued

Risks and Uncertainties

The Credit Union invests in various investment securities, including government agencies and mortgage-backed securities. Investment securities are exposed to various risks such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect the amounts reported in the statements of financial condition and statements of earnings.

Perpetual Contributed Capital

Kentucky Corporate Credit Union (KyCorp) requires that a capital share deposit be maintained for full participation as a member credit union. The deposit is based on the amount of each member credit union's total assets, and is not insured by the NCUSIF. Interest on the deposit is paid quarterly based on available earnings at interest rates approved by the Board of Directors of each of the corporate credit unions.

Membership capital shares can only be withdrawn after providing three-years notice. During 2011, KyCorp converted the existing membership capital shares to perpetual contributed capital to meet the requirements of the newly revised NCUA regulations. Perpetual contributed capital is not insured, has no maturity, and would not be returned to the Credit Union upon request without the approval of the NCUA. Perpetual contributed capital could be sold to another credit union if the Credit Union could find a willing buyer.

Federal Home Loan Bank Participation Stock

The Credit Union is a member in the Federal Home Loan Bank (FHLB). At December 31, 2013 and 2012, the Credit Union owned 17,113 shares of non-marketable participation stock for \$1,711,300, with quarterly stock and/or cash dividends.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 1 - Nature of Business and Significant Accounting Policies - Continued

New Accounting Pronouncements

A new accounting pronouncement has been issued by the Governmental Accounting Standards Board (GASB) to amend Statement No. 27 as it relates to Accounting and Financial Reporting for Pensions by governmental entities. The Credit Union's employees participate in a government sponsored pension plan. This proposal requires the governmental entity to recognize the actuarial projected benefit obligation due to employees under a state sponsored defined benefit pension plan. Currently, the pension plan only requires the Credit Union to reimburse the plan for the current obligations due to employees enrolled in the plan. However, the new accounting pronouncement requires the Credit Union to record a liability based on the actuarial projected benefit obligation. The Credit Union is not subject to GASB but is required to account for liabilities based on Generally Accepted Accounting Principles of the United States of America (GAAP). Under GAAP, a liability has been incurred if it is probable of payment and the amount can be measured. Management has acknowledged that this liability is probable of payment; however, the liability could not be measured as of December 31, 2013, since the records needed to measure this liability reside with the Kentucky Retirement System (KRS).

The new GASB amendment is required to be implemented for periods beginning after June 15, 2015. KRS has committed to providing the Credit Union with the plan measurement information needed to record the liability by December 31, 2015. The liability will be established with a charge to undivided earnings and will reduce the Credit Union's net worth ratio.

Reclassification/Presentation

Certain balances in the 2012 financial statements have been reclassified to conform to the 2013 presentation.

Subsequent Events

The financial statements and related disclosures include evaluation of events up through and including April 8, 2014, which is the date the financial statements were available to be issued.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012**Note 2 - Investment Securities**

The carrying amounts of investment securities as shown in the statements of financial condition of the Credit Union and their approximate fair values at December 31, 2013 are as follows:

	2013			
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized (Losses)</u>	<u>Fair Value</u>
Securities available-for-sale				
Federal agency securities	\$ 131,108,187	\$ 11,557	\$ (1,769,859)	\$ 129,349,885
Collateralized mortgage obligations	125,976,658	116,212	(4,823,489)	121,269,381
Mortgage-backed securities	27,264,994	-	(763,527)	26,501,467
Corporate bonds	<u>8,978,392</u>	<u>45,266</u>	<u>-</u>	<u>9,023,658</u>
Total available-for-sale	<u>\$ 293,328,231</u>	<u>\$ 173,035</u>	<u>\$ (7,356,875)</u>	<u>\$ 286,144,391</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 2 - Investment Securities - Continued

The amortized cost and estimated market value of debt securities, at December 31, 2013, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to sell or prepay obligations with or without sell or prepayment penalties:

	Securities Available-for-Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$ -	\$ -
Due in one year to five years	140,086,579	138,373,543
Collateralized mortgage obligations	125,976,658	121,269,381
Mortgage-backed securities	27,264,994	26,501,467
Total	\$293,328,231	\$286,144,391

Unrealized losses as of December 31, 2013 have not been recognized into income because they are not considered to be other-than-temporary. Management considers the unrealized losses to be market driven, rather than credit driven and no losses will be realized unless the securities are sold.

Description of Securities	Continuing Unrealized Losses For Less Than 12 Months		Continuing Unrealized Losses For 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Collateralized mortgage obligations	\$ 72,006,575	\$ (2,541,320)	\$ 41,466,178	\$ (2,282,169)	\$ 113,472,753	\$ (4,823,489)
Federal agency securities	115,569,635	(1,711,045)	9,250,200	(58,814)	124,819,835	(1,769,859)
Mortgage-backed securities	26,501,467	(763,527)	-	-	26,501,467	(763,527)
Total	\$214,077,677	\$ (5,015,892)	\$ 50,716,378	\$ (2,340,983)	\$ 264,794,055	\$ (7,356,875)

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012**Note 2 - Investment Securities - Continued**

The carrying amounts of investment securities as shown in the statements of financial condition of the Credit Union and their approximate fair values at December 31, 2012 are as follows:

	2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available-for-sale				
Federal agency securities	\$ 123,774,811	\$ 233,921	\$ (5,822)	\$ 124,002,910
Collateralized mortgage obligations	130,733,303	794,233	(125,371)	131,402,165
Mortgage-backed securities	22,719,449	42,170	-	22,761,619
Corporate bonds	9,011,454	45,744	-	9,057,198
Total available-for-sale	<u>\$ 286,239,017</u>	<u>\$ 1,116,068</u>	<u>\$ (131,193)</u>	<u>\$ 287,223,892</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012**Note 3 - Loans to Members**

The composition of loans to members is as follows:

	December 31,	
	2013	2012
Automobiles	\$ 177,522,711	\$ 163,918,947
Mortgage	226,872,279	207,906,634
Commercial	9,328,841	11,849,208
Home equity	45,227,379	44,996,383
Other secured	6,853,220	7,375,884
Unsecured	55,741,875	52,559,252
Credit card	69,505,600	66,489,194
Net deferred loan origination fees/costs	936,214	762,424
Total	591,988,119	555,857,926
Less: allowance for loan losses	6,450,444	5,508,634
Total loans to members	\$ 585,537,675	\$ 550,349,292

Loans on which the accrual of interest has been discontinued or reduced amounted to approximately \$5,500,000 and \$4,200,000 for the years ended December 31, 2013 and 2012, respectively. If interest on those loans had been accrued, such accrued income would have been approximately \$424,900 and \$326,700 for 2013 and 2012, respectively.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Allowance for Loan Losses and Recorded Investment in Loans

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method at December 31, 2013 and 2012:

	December 31, 2013			
	Consumer	Real Estate	Commercial	Total
Allowance for Loan Losses:				
Beginning balance	\$ 4,627,687	\$ 79,378	\$ 801,569	\$ 5,508,634
Charge-offs	(5,577,149)	(78,395)	(440,033)	(6,095,577)
Recoveries	874,063	12,572	71,340	957,975
Provision	5,150,109	176,683	752,620	6,079,412
Ending balance	5,074,710	190,238	1,185,496	6,450,444
Ending balance individually evaluated for impairment	-	-	1,185,496	1,185,496
Ending balance collectively evaluated for impairment	<u>\$ 5,074,710</u>	<u>\$ 190,238</u>	<u>\$ -</u>	<u>\$ 5,264,948</u>
Loans:				
Ending balance individually evaluated for impairment	\$ -	\$ -	\$ 9,328,841	\$ 9,328,841
Ending balance collectively evaluated for impairment	<u>309,623,404</u>	<u>272,099,658</u>	<u>-</u>	<u>581,723,062</u>
Total recorded investment in loans	<u>\$ 309,623,404</u>	<u>\$ 272,099,658</u>	<u>\$ 9,328,841</u>	<u>\$ 591,051,903</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Allowance for Loan Losses and Recorded Investment in Loans - Continued

	December 31, 2012			
	Consumer	Real Estate	Commercial	Total
Allowance for Loan Losses:				
Beginning balance	\$ 4,476,497	\$ 97,317	\$ 1,099,010	\$ 5,672,824
Charge-offs	(3,952,874)	(99,848)	(318,537)	(4,371,259)
Recoveries	791,040	17,293	118,064	926,397
Provision	3,313,024	64,616	(96,968)	3,280,672
Ending balance	4,627,687	79,378	801,569	5,508,634
Ending balance individually evaluated for impairment	-	-	801,569	801,569
Ending balance collectively evaluated for impairment	<u>\$ 4,627,687</u>	<u>\$ 79,378</u>	<u>\$ -</u>	<u>\$ 4,707,065</u>
Loans:				
Ending balance individually evaluated for impairment	\$ -	\$ -	\$ 11,849,208	\$ 11,849,208
Ending balance collectively evaluated for impairment	<u>290,343,277</u>	<u>252,903,017</u>	<u>-</u>	<u>543,246,294</u>
Total recorded investment in loans	<u>\$ 290,343,277</u>	<u>\$ 252,903,017</u>	<u>\$ 11,849,208</u>	<u>\$ 555,095,502</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Impaired Loans

Loan impairment is measured by estimating the expected future cash flows or by valuing the underlying collateral. The following tables present loans individually evaluated for impairment by class of loans as of December 31, 2013 and 2012:

		December 31, 2013									
		<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>					
With No Related Allowance Recorded:											
Commercial	\$	481,128	\$	481,128	\$	-	\$	552,733	\$	31,752	
With An Allowance Recorded:											
Commercial	\$	1,771,800	\$	1,771,800	\$	1,185,496	\$	1,780,989	\$	91,427	
Total:											
Commercial	\$	2,252,928	\$	2,252,928	\$	1,185,496	\$	2,333,722	\$	143,179	

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Impaired Loans - Continued

	December 31, 2012				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With No Related Allowance Recorded:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
With An Allowance Recorded:					
Commercial	\$ 3,731,142	\$ 3,592,283	\$ 801,569	\$ 3,286,548	\$ 206,135
Total:					
Commercial	<u>\$ 3,731,142</u>	<u>\$ 3,592,283</u>	<u>\$ 801,569</u>	<u>\$ 3,286,548</u>	<u>\$ 206,135</u>

COMMONWEALTH CREDIT UNION**NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012****Note 3 - Loans to Members - Continued****Credit Quality Indicators**

The Credit Union categorizes member business loans into risk categories based on relevant information about the ability of the borrower to service their debts such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Credit Union analyzes member business loans individually by classifying the loans as to credit risk. This analysis is limited to member business loans. The Credit Union uses the following definitions for classified risk rating:

Special Mention - A Special Mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the obligor's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Substandard - A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful - An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Credit Quality Indicators - Continued

Loans not meeting the criteria on the previous page that are analyzed individually as part of the previously described process are considered to be prime or pass rated loans. At December 31, 2013 and 2012, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

		December 31, 2013				
		Pass	Special Mention	Substandard	Doubtful	Total
Commercial		\$ 7,075,912	\$ 365,118	\$ 627,288	\$ 1,260,523	\$ 9,328,841
		December 31, 2012				
		Pass	Special Mention	Substandard	Doubtful	Total
Commercial		\$ 7,732,383	\$ 1,701,264	\$ 699,381	\$ 1,716,180	\$ 11,849,208

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Credit Quality Indicators - Continued

The Credit Union considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Credit Union also evaluates credit quality based on the aging status of the loan, which was previously presented and by payment activity. The following tables present the recorded investment in residential and consumer loans based on payment activity as of December 31, 2013 and 2012:

December 31, 2013							
	Direct Automobile	Indirect Automobile	Unsecured Personal	Unsecured Credit Cards	Other Secured	First/Second Mortgage	Totals
Performing	\$ 78,804,660	\$ 65,902,890	\$ 55,207,667	\$ 69,033,406	\$ 6,735,226	\$ 225,350,330	\$ 575,942,211
Non-Performing	953,985	1,861,486	556,949	481,105	117,994	1,521,949	5,803,774
Total	\$ 79,758,645	\$ 67,764,376	\$ 55,764,616	\$ 69,514,511	\$ 6,853,220	\$ 226,872,279	\$ 581,746,005

December 31, 2012							
	Direct Automobile	Indirect Automobile	Unsecured Personal	Unsecured Credit Cards	Other Secured	First/Second Mortgage	Totals
Performing	\$ 72,562,728	\$ 88,748,224	\$ 51,889,680	\$ 65,977,074	\$ 7,330,872	\$ 207,375,210	\$ 538,725,815
Non-Performing	844,066	1,763,989	701,527	512,160	45,012	531,424	4,552,634
Total	\$ 73,406,794	\$ 90,512,213	\$ 52,591,207	\$ 66,489,164	\$ 7,375,884	\$ 207,906,634	\$ 543,278,449

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Age Analysis of Past Due Loans

The following table presents the aging of the recorded investment in past due loans at December 31, 2013 and 2012:

	December 31, 2013					December 31, 2012				
	30-60 Days Past Due	Greater Than 60 Days Past Due	Total Past Due	Current	Total Loans	30-60 Days Past Due	Greater Than 60 Days Past Due	Total Past Due	Current	Total Loans
Direct Automobile	\$ 912,290	\$ 953,985	\$ 1,866,275	\$ 77,872,370	\$ 79,738,645	\$ 785,026	\$ 844,086	\$ 1,629,012	\$ 71,777,702	\$ 73,406,714
Indirect Automobile	2,669,220	1,361,400	4,030,706	93,233,860	97,264,066	2,297,918	1,763,999	4,061,907	86,450,106	90,512,213
Unsecured Personal	493,775	556,949	1,050,724	54,691,149	55,741,873	316,190	701,527	1,017,717	51,341,515	52,359,252
Unsecured Credit Cards	450,484	481,105	931,589	68,574,011	69,505,600	521,715	512,160	1,033,875	63,455,319	64,489,194
Other Secured	114,636	117,094	231,730	6,620,590	6,852,320	11,015	43,012	54,027	7,319,857	7,373,884
First/Second Mortgage	1,437,086	1,621,949	2,959,555	223,912,724	226,872,279	210,462	531,424	741,886	207,164,748	207,906,634
HELOC	98,197	310,306	408,703	44,818,676	45,227,379	335,701	154,516	490,217	44,096,160	44,996,383
Commercial	670,423	1,779,037	2,449,460	6,558,361	9,007,821	309	675,944	676,253	11,172,955	11,849,208
Total	\$ 6,806,831	\$ 7,573,831	\$ 14,380,662	\$ 576,611,241	\$ 591,051,903	\$ 4,578,336	\$ 5,228,578	\$ 9,806,914	\$ 545,288,568	\$ 555,095,502
										\$ 1,814,082
Direct Automobile										
Indirect Automobile										
Unsecured Personal										
Unsecured Credit Cards										
Other Secured										
First/Second Mortgage										
HELOC										
Commercial										

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COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 3 - Loans to Members - Continued

Troubled Debt Restructurings

The following tables present modified loans by class of loans which were troubled debt restructurings as of December 31, 2013 and 2012:

	2013				2012			
	Pre-		Post-		Pre-		Post-	
	Number of Contracts	Modification Outstanding Recorded Investment	Number of Contracts	Modification Outstanding Recorded Investment	Number of Contracts	Modification Outstanding Recorded Investment	Number of Contracts	Modification Outstanding Recorded Investment
Troubled Debt Restructurings- Consumer	-	\$ -	-	\$ -	-	\$ -	-	\$ -
First/Second Mortgage	7	338,756	-	318,081	5	291,732	-	276,979
Commercial	7	2,645,606	6	1,916,095	6	1,888,529	-	1,549,953
	2013		2012		2013		2012	
	Number of Contracts	Charged-off Amount	Number of Contracts	Charged-off Amount	Number of Contracts	Charged-off Amount	Number of Contracts	Charged-off Amount
Troubled Debt Restructurings that Subsequently Defaulted								
Consumer	-	\$ -	-	\$ -	-	\$ -	-	\$ -
First/Second Mortgage	-	-	-	-	-	-	-	-
Commercial	2	735,674	1	236,491	1	236,491	1	236,491

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 4 - Property and Equipment

The principal categories of property and equipment may be summarized as follows:

	December 31,	
	2013	2012
Land and improvements	\$ 5,086,080	\$ 3,468,245
Building and improvements	28,351,543	24,868,318
Furniture and equipment	9,343,930	8,458,752
Computer equipment	2,939,821	2,964,480
Total cost	45,721,374	39,759,795
Less accumulated depreciation	21,609,960	20,550,061
Undepreciated cost	\$ 24,111,414	\$ 19,209,734

Note 5 - Borrowed Funds

The Credit Union has a line-of-credit available from Kentucky Corporate Federal Credit Union at a variable rate of interest, guaranteed by all assets, maximum credit available of \$10,000,000 at December 31, 2013 and 2012. There were no funds borrowed under the line-of-credit outstanding at December 31, 2013 and 2012.

During the year, the Credit Union established a borrowing facility with the Federal Reserve. Any future borrowed funds with this facility will be secured by collateralized assets. The Credit Union did not borrow against this facility and had no balance payable as of December 31, 2013.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 6 - Members' Shares and Savings Accounts

	December 31,	
	2013	2012
Share accounts	\$ 355,024,591	\$ 332,365,432
Individual retirement accounts	21,362,377	21,184,441
Share draft accounts	96,189,112	90,200,925
Money market accounts	94,234,533	94,135,011
Certificates of deposit and IRA certificates	<u>189,389,233</u>	<u>204,473,733</u>
Total	<u>\$ 756,199,846</u>	<u>\$ 742,359,542</u>

At December 31, 2013, scheduled maturities of certificates of deposit and IRA certificates are as follows:

2014	\$ 116,179,810
2015	40,744,307
2016	17,190,709
2017	5,930,873
2018	8,198,460
Thereafter	<u>1,145,074</u>
Total	<u>\$ 189,389,233</u>

Interest expense on members' share accounts is summarized as follows:

	December 31,	
	2013	2012
Share accounts	\$ 510,159	\$ 496,827
Individual retirement accounts	36,422	44,451
Share draft accounts	85,715	78,339
Money market accounts	171,468	207,670
Certificates of deposit and IRA certificates	<u>2,407,733</u>	<u>3,171,549</u>
Total	<u>\$ 3,211,497</u>	<u>\$ 3,998,836</u>

The aggregate amount of time deposit accounts in denominations of \$100,000 or more at December 31, 2013 were approximately \$48,310,000.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 7 - Members' Equity

Regulatory Capital

The Credit Union is subject to various regulatory capital requirements administered by its primary federal regulator, the NCUA. Failure to meet the minimum regulatory capital requirements can initiate certain mandatory, and possible additional discretionary actions by regulators, that if undertaken, could have a direct material effect on the Credit Union's financial statements. Under the regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital guidelines involving quantitative measures of the Credit Union's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios of net worth to total assets. Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not a credit union will be considered complex under the regulatory framework. The Credit Union's RBNWR ratio as of December 31, 2013 and 2012 was 6.53% and 6.05%, respectively. The minimum ratio to be considered complex under the regulatory framework is 6.0%. Management believes as of December 31, 2013 and 2012, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2013 and 2012, the Credit Union was categorized as well capitalized under the regulatory framework for prompt corrective action.

	<u>Actual</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provision</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
December 31, 2013				
Net Worth	\$ 184,279,459	19.52%	\$ 66,078,414	7.00%
December 31, 2012				
Net Worth	\$ 174,935,454	18.85%	\$ 64,962,201	7.00%

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 8 - Related Party Transactions

The majority of employees and all members of the Board of Directors have member accounts at the Credit Union, including share, deposit and loan accounts. The terms of transactions involving these accounts (i.e., rates charged and paid) are comparable to other members.

Included in loans receivable at December 31, 2013 and 2012 are loans of \$1,217,090 and \$697,598, respectively, to directors and executive officers of the Credit Union. Such loans are made in the ordinary course of business at normal credit terms including interest rates and collateralization.

Note 9 - Commitments and Contingent Liabilities

The principal commitments of the Credit Union are as follows:

Lease Commitments

At December 31, 2013 and 2012, the Credit Union had outstanding commitments under operating leases for ATMs. Net rent expense under the operating leases, included in expenses, was \$224,000 and \$263,000, respectively, for the years ended December 31, 2013 and 2012.

The projected minimum rental payments under the terms of the leases at December 31, 2013 are as follows:

Year Ending December 31st:

2014	\$	75,060
2015		34,695
2016		15,930
2017		-
2018		-

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 9 - Commitments and Contingent Liabilities - Continued

Loan Commitments

At December 31, 2013, the Credit Union had outstanding commitments for unused lines-of-credit that are not reflected in the accompanying financial statements, as follows:

Home equity	\$ 54,355,592
Overdraft protection	611,642
Lines-of-credit	47,131,329
Credit cards	<u>153,722,398</u>
Total	<u>\$ 255,820,961</u>

The Credit Union is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statements of financial condition. The contract or notional amounts of those instruments reflect the extent of involvement the Credit Union has in particular classes of financial instruments.

The Credit Union's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual notional amount of those instruments. The Credit Union uses the same credit policies in making commitments as it does for on-balance sheet instruments.

Financial instruments whose contract amounts represent credit risk:

Commitments to extend credit, generally unsecured	\$ 201,465,369
Commitments to extend credit, home equity secured	<u>54,355,592</u>
Total	<u>\$ 255,820,961</u>

Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have termination clauses or fixed expiration dates. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Credit Union evaluates each member's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Credit Union upon extension of credit, is based on management's credit evaluation of the member and classification of loan.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 10 - Fair Values of Financial Instruments

The Credit Union uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted prices for the Credit Union's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value of other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of a financial instrument.

The definition of fair value focuses on exit price in an orderly transaction between market participants at the measurement date under current market conditions, other than in a forced liquidation or distressed sale. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in the valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

The following methods and assumptions were used by the Credit Union in estimating fair value disclosures for the financial statements:

Cash and Cash Equivalents/Non-Negotiable Certificates of Deposit

The carrying amount approximates fair value due to the short-term nature of these instruments.

Investment Securities

Fair values have been determined using significant observable inputs for all investment securities.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 10 - Fair Values of Financial Instruments - Continued

Loans Receivable

Fair value is based on the discounted value of future cash flows expected to be received for a loan or group of loans using current rates at which similar loans would be made to borrowers with similar credit ratings and the same remaining maturities. This method considers interest rate changes and credit risk changes within the discount rate chosen. A single discount rate is applied to homogeneous categories of loans such as credit cards and automobile loans.

Members' Shares and Savings Accounts

The fair value of member deposits (savings accounts, share drafts, and deposit accounts) having no fixed maturity is the amount payable on demand at the reporting date.

Certificate of Deposit Accounts

The fair value of fixed maturity certificates of deposit and IRA certificates is estimated using the rates currently offered for deposits with similar remaining maturities.

Commitments to Extend Credit

The estimate of fair value of the commitments to extend credit represents the Credit Union's potentially unfunded commitments under such lines-of-credit.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 10 - Fair Values of Financial Instruments - Continued

The carrying amounts and estimated fair values of the Credit Union's financial instruments at December 31, 2013 and 2012, are as follows:

	December 31,			
	2013		2012	
	Carrying Amounts	Fair Value	Carrying Amounts	Fair Value
Financial Assets				
Cash and cash equivalents	\$ 24,899,993	\$ 24,899,993	\$ 47,386,051	\$ 47,386,051
Non-negotiable certificates of deposit	5,416,000	5,416,000	5,416,000	5,416,000
Investment securities	286,144,391	286,144,391	287,223,892	287,223,892
Loans receivable	591,988,119	582,569,475	555,857,926	553,172,000
Less: allowance for loan losses	(6,450,444)	-	(4,415,026)	-
	<u>\$ 901,975,114</u>	<u>\$ 899,029,859</u>	<u>\$ 891,436,688</u>	<u>\$ 893,197,943</u>
Financial Liabilities				
Members' shares and savings accounts	<u>\$ 756,199,846</u>	<u>\$ 750,637,911</u>	<u>\$ 742,359,542</u>	<u>\$ 741,857,000</u>
Unrecognized Financial Instruments				
Commitments to extend credit	<u>\$ -</u>	<u>\$ 255,820,961</u>	<u>\$ -</u>	<u>\$ 229,092,000</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 11 - Fair Value Measurements

Accounting standards require certain assets and liabilities be reported at fair value in the financial statements and provide a framework for establishing that fair value. The framework for determining fair value is based on a hierarchy that prioritizes the inputs and valuation techniques used to measure fair value.

The following table presents information about the Credit Union's assets measured at fair value on a recurring basis at December 31, 2013 and 2012 and the valuation techniques used by the Credit Union to determine those fair values. The three levels of the fair value hierarchy are described below:

Basis of Fair Value Measurements

- Level 1** - Valuation is based on quoted market prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2** - Valuation is based on inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
- Level 3** - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined by using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 11 - Fair Value Measurements - Continued

Assets Measured at Fair Value on a Recurring Basis

Assets measured at fair value on a recurring basis at December 31, 2013 and 2012 are summarized as follows:

	Fair Value Measurements at December 31, 2013, Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Available-for-sale securities	\$ —	\$ 286,144,391	\$ —	\$ 286,144,391

	Fair Value Measurements at December 31, 2012, Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Available-for-sale securities	\$ —	\$ 287,223,892	\$ —	\$ 287,223,892

Valuation Methods for Instruments Measured at Fair Value on a Non-Recurring Basis

The following is a description of the Credit Union's valuation methodologies used for assets and liabilities recorded at fair value on a non-recurring basis:

Impaired Loans

The Credit Union does not record loans at fair value on a recurring basis. However, on occasion, a loan is considered impaired and an allowance for loan loss is established. A loan is considered impaired when it is probable that all of the principal and interest under the original terms of the loan may not be collected. Once a loan is identified as individually impaired, management measures the impairment in accordance with the criteria described in Note 1. Impaired loans where an allowance is established based on fair value of collateral require classification in the fair value hierarchy. When fair value of the collateral is based on an observable market price or current appraised value, the Credit Union records the impaired loans as non-recurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Credit Union records the impairment value as non-recurring Level 3.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2013 AND 2012

Note 11 - Fair Value Measurements - Continued

Valuation Methods for Instruments Measured at Fair Value on a Non-Recurring Basis - ContinuedOther Real Estate Owned

Other real estate owned assets are reported in the following non-recurring table at initial recognition of impairment and on an ongoing basis until recovery or charge-off. At the time of foreclosure or repossession, real estate owned and repossessed assets are adjusted to their fair value less costs to sell upon transfer of the loans to real estate owned and repossessed assets, establishing a new cost basis. At that time, they are reported in the Credit Union's fair value disclosures in the following non-recurring table.

Assets Measured at Fair Value on a Non-Recurring Basis

Fair Value Measurements At December 31, 2013, Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Impaired loans	\$ -	\$ 2,252,928	\$ -	\$ 2,252,928
Other real estate owned	-	597,453	-	597,453
Total	\$ -	\$ 2,850,381	\$ -	\$ 2,850,381

Fair Value Measurements At December 31, 2012, Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Impaired loans	\$ -	\$ 3,592,283	\$ -	\$ 3,592,283
Other real estate owned	-	884,969	-	884,969
Total	\$ -	\$ 4,477,252	\$ -	\$ 4,477,252

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 12 – Defined Benefit Pension Plan and Postemployment Benefits

Plan Description

The Credit Union participates in the Kentucky Employees' Retirement System (KERS), which is a cost-sharing multiple-employer defined benefit pension plan that covers substantially all regular full-time Credit Union employees. The plan provides for retirement, disability, and death benefits to plan members. Retirement benefits may be extended to beneficiaries of plan members under certain circumstances.

This system is one of three systems administered under one administrative agency known as the Kentucky Retirement System (KRS). The KRS issues a publicly available financial report that includes financial statements and required supplementary information for each system it administers. That report may be obtained online. The most recent annual report is as of June 30, 2013.

Actuarial Funding

KRS administers both a pension fund and an insurance fund for each of the systems it manages. These trusts are used to fund monthly pension and health care payments to and on behalf of retirees. Non-hazardous (Credit Union employees are within this classification) employees are statutorily required to contribute 5% of pre-tax salary to their pension benefit. All employees hired with an initial participation date on or after September 1, 2008 must contribute an additional 1% of their pre-tax compensation toward their retiree health insurance benefits. These monies are deposited in a 401(h) account within the pension trust. Employer contributions are calculated annually by the Board of Trustees and include the normal cost of pension and insurance benefits plus a contribution toward the unfunded liability of the pension and insurance trusts designed to amortize that liability over a period no longer than 30 years. Employer contributions also include an administrative fee that is used to pay annual operating expenses of KRS. The administrative expense is shared among the plans based on the ratio of a plan's membership to the total system membership at the beginning of a fiscal year.

As of June 30, 2013 (the date of the most recent KERS comprehensive annual financial report), the funded ratio of the KERS nonhazardous pension plan is 23.20% of the actuarial value of assets.

The Credit Union's contributions to the KERS plan for the years ended December 31, 2013 and 2012 were approximately \$2,953,000, and \$2,470,000, respectively.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2013 AND 2012

Note 12 - Defined Benefit Pension Plan and Postemployment Benefits - Continued

Actuarial Funding - Continued

The Credit Union makes a contribution, which includes both insurance and pension to the KERS for employees. The contribution rate was 25.20% for the period from January 1, 2013 through December 31, 2013 and 21.71% for the period from January 1, 2012 through December 31, 2012.

Postemployment Benefits

Participation in the insurance program is optional and requires the completion of the proper forms at the time of retirement in order to obtain the insurance coverage. The KERS provides access to health insurance coverage through the Kentucky Employees Group Health Plan (KEHP) for recipients until they reach age 65 and/or become Medicare eligible. After a retired member becomes eligible for Medicare, coverage is available through a Medicare eligible plan offered by the KERS. A retired member's spouse and/or dependents may also be covered on health insurance through the KERS. Required contributions for postemployment health care benefits are included as part of the Credit Union's total contribution to the KERS plan discussed above.



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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Supervisory Committee
of **Commonwealth Credit Union**

Report on the Financial Statements

We have audited the accompanying financial statements of Commonwealth Credit Union, which comprise the statements of financial condition as of December 31, 2014 and 2013, and the related statements of earnings, comprehensive income, members' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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Auditor's Responsibility - Continued

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Commonwealth Credit Union as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Doeren Mayhew

Troy, Michigan
February 7, 2015

COMMONWEALTH CREDIT UNION

STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2014 AND 2013

<u>Assets</u>	<u>2014</u>	<u>2013</u>
Cash and cash equivalents	\$ 21,658,062	\$ 24,899,993
Non-negotiable certificates of deposit	4,216,000	5,416,000
Investment securities (note 2):		
Available-for-sale	267,408,381	286,144,391
Loans to members, net of allowance for loan losses (note 3)	640,004,346	585,537,675
Accrued interest receivable	2,900,784	2,753,674
Property and equipment (note 4)	26,407,233	24,111,414
NCUSIF deposit (note 1)	7,843,610	7,559,122
Federal Home Loan Bank participation stock (note 1)	1,711,300	1,711,300
Perpetual contributed capital (note 1)	691,987	691,987
Other real estate owned (note 1)	716,507	597,453
Other assets	5,646,149	4,554,327
Total assets	<u>\$ 979,204,359</u>	<u>\$ 943,977,336</u>
<u>Liabilities and Members' Equity</u>		
Liabilities:		
Members' shares and savings accounts (note 6)	\$ 780,199,260	\$ 756,199,846
Accounts payable	5,120,172	5,758,074
Other accrued liabilities	5,441,003	4,923,800
Total liabilities	790,760,435	766,881,720
Commitments and contingent liabilities (note 9)	-	-
Members' equity - substantially restricted (note 7)	<u>188,443,924</u>	<u>177,095,616</u>
Total liabilities and members' equity	<u>\$ 979,204,359</u>	<u>\$ 943,977,336</u>

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

STATEMENTS OF EARNINGS
YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
Interest income:		
Loans receivable	\$ 34,781,663	\$ 34,484,516
Investment securities	3,841,060	3,966,965
Total interest income	38,622,723	38,451,481
Interest expense:		
Interest and dividends on members' shares and savings accounts	2,882,895	3,211,497
Interest on borrowed funds	102	2
Total interest expense	2,882,997	3,211,499
Net interest income	35,739,726	35,239,982
Provision for loan losses	5,176,012	6,079,412
Net interest income after provision for loan losses	30,563,714	29,160,570
Non-interest income:		
Fees and charges	13,606,680	12,298,905
Non-interest expenses:		
Compensation and benefits	20,852,069	18,391,014
Office operations	9,364,028	8,623,759
Occupancy	1,955,048	1,637,845
Operating expenses	4,044,704	2,857,151
TCCUSF assessments (note 1)	-	605,705
Total non-interest expenses	36,215,849	32,115,474
Net earnings	\$ 7,954,545	\$ 9,344,001

See accompanying notes to financial statements.

COMMONWEALTH CREDIT UNION
STATEMENTS OF COMPREHENSIVE INCOME
YEARS ENDED DECEMBER 31, 2014 AND 2013

	<u>2014</u>	<u>2013</u>
Net earnings	\$ 7,954,545	\$ 9,344,001
Other comprehensive income (loss):		
Net changes in unrealized gains (loss) on investments classified as available-for-sale	<u>3,393,763</u>	<u>(8,168,714)</u>
Comprehensive income	<u>\$ 11,348,308</u>	<u>\$ 1,175,287</u>

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

STATEMENTS OF MEMBERS' EQUITY
YEARS ENDED DECEMBER 31, 2014 AND 2013

	Appropriated Statutory	Undivided Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
Members' equity - January 1, 2013	\$ 20,827,421	\$ 154,108,033	\$ 984,875	\$ 175,920,329
Comprehensive income (loss)	-	9,344,001	(8,168,714)	1,175,287
Members' equity - December 31, 2013	20,827,421	163,452,034	(7,183,839)	177,095,616
Comprehensive income	-	7,954,545	3,393,763	11,348,308
Members' equity - December 31, 2014 (note 7)	<u>\$ 20,827,421</u>	<u>\$ 171,406,579</u>	<u>\$ (3,790,076)</u>	<u>\$ 188,443,924</u>

See accompanying notes to financial statements.

COMMONWEALTH CREDIT UNION

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
Cash flows from operating activities:		
Net earnings	\$ 7,954,545	\$ 9,344,001
Adjustments:		
Depreciation	1,622,485	1,473,368
Provision for loan losses	5,176,012	6,079,412
Gain on sale of investments	(15,143)	(8,910)
Amortization of deferred loan origination fees	977,698	828,582
Net amortization/accretion of premiums/discounts on investments	924,979	(524,993)
Loss on sale of other real estate owned	32,750	52,476
Gain on sale of participation loans	(446,547)	-
Recoveries on charged-off loans	2,007,274	957,974
Changes in assets and liabilities:		
(Increase) decrease in accrued interest receivable	(147,110)	151,331
(Increase) decrease in prepaids and other assets	(1,091,822)	131,561
(Decrease) increase in accounts payable	(637,902)	343,300
Increase in other accrued liabilities	517,203	587,004
Total adjustments	8,919,877	10,071,105
Net cash provided from operating activities	16,874,422	19,415,106

See accompanying notes to financial statements.

COMMONWEALTH CREDIT UNION

STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
Cash flows from investing activities:		
Increase in loans to members (net)	\$ (88,992,195)	\$ (44,352,485)
Decrease in non-negotiable certificates of deposit (net)	1,200,000	-
Proceeds from maturities of investment securities:		
Available-for-sale	60,184,903	93,341,846
Proceeds from sales of investment securities:		
Available-for-sale	4,618,917	15,008,910
Purchases of investment securities:		
Available-for-sale	(43,583,883)	(114,946,377)
(Increase) decrease in share insurance deposit, net of impairment	(284,488)	8,201
Acquisition of property and equipment	(3,918,304)	(6,375,048)
Proceeds from sale of participation loans	25,963,499	-
Proceeds from sale of other real estate owned	695,784	1,573,485
Net cash used in investing activities	(44,115,767)	(55,741,468)
Cash flows from financing activities:		
Increase in members' shares and savings accounts (net)	23,999,414	13,840,304
Net decrease in cash and cash equivalents	(3,241,931)	(22,486,058)
Cash and cash equivalents - beginning	24,899,993	47,386,051
Cash and cash equivalents - ending	<u>\$ 21,658,062</u>	<u>\$ 24,899,993</u>
<u>Supplemental Information</u>		
Non-cash increase in other real estate owned	<u>\$ 847,588</u>	<u>\$ 1,298,133</u>
Interest and dividends paid	<u>\$ 2,882,997</u>	<u>\$ 3,211,499</u>

See accompanying notes to financial statements

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 1 - Nature of Business and Significant Accounting Policies

Nature of Business

Commonwealth Credit Union is a cooperative association organized in accordance with Chapter 290 of the Kentucky State Chartered Credit Union Law. Commonwealth Credit Union's operations are principally related to holding deposits for and making loans to employees of the Commonwealth of Kentucky and their families.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The statements of cash flows classify changes in cash or cash equivalents (short-term, highly liquid investments readily convertible into cash with an original maturity of three months or less) according to operating, investing or financing activities. Financial instruments which potentially subject the Credit Union to concentrations of credit risk consist principally of cash and temporary cash investments. At times, cash balances held at financial institutions were in excess of the Federal Deposit Insurance Corporation (FDIC) insurance limits. The Credit Union places its temporary cash investments with high-credit, quality financial institutions and, by policy, limits the amount of credit exposure to any one financial institution. The Credit Union believes no significant concentration of credit risk exists with respect to these cash investments.

Investment Securities

The Credit Union's investments in securities for the years ended December 31, 2014 and 2013 are classified and accounted for as follows:

Available-for-Sale Securities

Securities available-for-sale consists of securities not otherwise classified as trading securities or securities to be held-to-maturity and are recorded at fair value, with unrealized gains and losses excluded from earnings and reported in accumulated other comprehensive income (loss).

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 1 - Nature of Business and Significant Accounting Policies (Continued)

Investment Securities (Continued)

Gains and losses on sales of securities available-for-sale are determined using the specific-identification method.

Declines in the fair value are available-for-sale securities below their cost that are other-than-temporary are reflected as realized losses. In estimating other-than-temporary impairment, management considers: (1) the Credit Union's intent to sell the debt security prior to recovery and, (2) whether it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. If the Credit Union does not intend to sell a security, and it is more likely than not, the Credit Union will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in accumulated other comprehensive income (loss).

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

NCUSIF Deposit and Insurance Premium

The deposit in the National Credit Union Share Insurance Fund (NCUSIF) is in accordance with the National Credit Union Association (NCUA) regulations, which require the maintenance of a deposit by each insured credit union in an amount equal to one percent of its insured shares. The deposit would be refunded to the credit union if its insurance coverage is terminated, it converts to insurance coverage from another source, or the operations of the fund are transferred from the NCUA Board. No dividends were paid for the years ended December 31, 2014 and 2013. The NCUSIF deposit is required to be reviewed for impairment, including consideration of the refundability of the deposit.

The NCUA assessed all federally insured credit unions premiums of 0.08% for 2013 of insured shares for the repayment of the funds borrowed from the Treasury Department by the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). The Credit Union paid the assessment related to the TCCUSF of approximately \$606,000 during the year ended December 31, 2013. A premium was not assessed for 2014.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 1 - Nature of Business and Significant Accounting Policies (Continued)

Loans to Members

Loans that the Credit Union has the intent and ability to hold for the foreseeable future are stated at unpaid principal balances, less an allowance for loan losses and net deferred loan origination fees and discounts. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding.

The accrual of interest on loans is discontinued on a loan when a loan exceeds 90 days delinquent or when management believes, after considering economics, business conditions, and collection efforts that the borrowers' financial condition is such that collection of interest is doubtful.

Certain direct loan origination costs are deferred and recognized as an adjustment to interest income using the straight-line method over the contractual life of the loans. The straight-line method, which is not in accordance with generally accepted accounting principles, is not materially different from the interest method, which is required under generally accepted accounting principles.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 1 - Nature of Business and Significant Accounting Policies (Continued)

Allowance for Loan Losses (Continued)

The Credit Union's allowance for loan losses is that amount considered adequate to absorb probable losses in the portfolio based on management's evaluations of the size and current risk characteristics of the loan portfolio. Such evaluations consider prior loss experience, the risk rating distribution of the portfolios, the impact of current internal and external influences on credit loss and the levels of non-performing loans. Specific allowances for loan losses are established for large impaired loans on an individual basis as required by generally accepted accounting principles. The specific allowances established for these loans is based on a thorough analysis of the most probable source of repayment, including the present value of the loan's expected future cash flow, the loan's estimated market value, or the estimated fair value of the underlying collateral. General allowances are established for loans that can be grouped into pools based on similar characteristics as described in generally accepted accounting principles. In this process, general allowance factors are based on an analysis of historical charge-off experience and expected losses given default derived from the Credit Union's internal risk rating process. These factors are developed and applied to the portfolio in terms of loan type. The qualitative factors associated with the allowances are subjective and require a high degree of management judgment. These factors include the credit quality statistics, recent economic uncertainty, losses incurred from recent events and lagging data.

The following portfolio segments have been identified: consumer, real estate, and commercial. The Credit Union divides these segments into classes based on the associated risks within those segments. Consumer loans are divided into the following classes: Vehicle, Unsecured, and Other Secured. Member owned real estate loans are divided into the following classes: First and Second Mortgages and Home Equity Loans. Commercial loans are participation loans primarily secured by commercial real estate.

A loan is impaired when full payment under the loan terms is not expected. Real estate and commercial loans are evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Real estate loans for which the terms have been modified and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and are classified as impaired. Troubled debt restructurings are measured at the present value of estimated future cash flows using the loans effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 1 - Nature of Business and Significant Accounting Policies (Continued)

Assets Acquired in Liquidation of Loans

Assets acquired in liquidation of loans represent collateral used to secure members' loans that have been acquired by the Credit Union in an effort to settle the members' loans and are recorded at the lower of cost or market less costs of liquidation.

Upon acquisition, the Credit Union determines fair value of the collateral and any losses are charged-off through the allowance for loan losses. The Credit Union continues to review these properties for subsequent impairment and any subsequent declines in fair value are recorded through current period earnings.

Income Taxes

The Credit Union is exempt, by statute (IRC Section 501(c)14), from Federal income taxes and Kentucky Business tax.

The Credit Union is a state-chartered credit union described in Internal Revenue Code ("IRC") Section 501(c)(14). As such, the Credit Union is exempt from federal taxation of income derived from the performance of activities that are in furtherance of its exempt purposes. However, IRC Section 511 imposes a tax on the unrelated business income (as defined in Section 512) derived by state-chartered credit unions. Many states have similar laws. The specific application of Section 512 to the various activities conducted by state-chartered credit unions has been an issue for many years. In 2007, the Internal Revenue Service ("IRS") issued a series of Technical Advice Memoranda ("TAM") to a number of state-chartered credit unions located throughout the country. In these TAMs, the IRS ruled certain products and services to be subject to taxation as unrelated business income. In light of the TAMs, the Credit Union has assessed its activities and any potential federal or state income tax liability. In the opinion of management, any liability arising from federal or state taxation of activities deemed to be unrelated to its exempt purpose is not expected to have a material effect on the Credit Union's financial condition or results of operations.

Members' Shares and Savings Accounts

Members' shares are subordinated to all other liabilities of the Credit Union upon liquidation. Interest on members' shares and savings accounts is based on available earnings at the end of an interest period and is not guaranteed by the Credit Union. Interest rates on members' shares accounts are set by the Board of Directors, based on an evaluation of current and future market conditions.

COMMONWEALTH CREDIT UNION**NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013**

Note 1 - Nature of Business and Significant Accounting Policies (Continued)Risks and Uncertainties

The Credit Union invests in various investment securities, including government agencies and mortgage-backed securities. Investment securities are exposed to various risks such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such change could materially affect the amounts reported in the statements of financial condition and statements of earnings.

Perpetual Contributed Capital

The Credit Union maintains perpetual contributed capital (PCC) with Volunteer Corporate Credit Union (VolCorp). The PCC is not subject to share insurance coverage by the NCUSIF or other deposit insurer. The PCC is not releasable due solely to merger, charter conversion or liquidation and is callable at the option of VolCorp. The PCC has a perpetual maturity and a noncumulative dividend.

Federal Home Loan Bank Participation Stock

The Credit Union is a member in the Federal Home Loan Bank (FHLB). At December 31, 2014 and 2013, the Credit Union owned 17,113 shares of non-marketable participation stock for \$1,711,300, with quarterly stock and/or cash dividends.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 1 - Nature of Business and Significant Accounting Policies (Continued)

New Accounting Pronouncements

A new accounting pronouncement has been issued by the Governmental Accounting Standards Board (GASB) as it relates to accounting and reporting of pensions by governmental entities. The Credit Union's employees participate in a government sponsored plan. The pronouncement requires the plan to provide sufficient information to the entity for it to be able to recognize a liability for its share of the actuarial projected benefit due to its employees. Currently, the plan only requires and provides information for the Credit Union to reimburse the plan for the current obligations due to the employees enrolled in the plan. The Credit Union is not subject to GASB pronouncements, but is required to account for liabilities based on accounting principles generally accepted in the United States of America (GAAP). GAAP requires recognition of a liability if it is probable of payment and the amount can be measured, and thus requires the Credit Union to record a liability for the actuarial projected benefit obligation. Management has acknowledged that this liability is probable of payment; however, the liability could not be measured as of December 31, 2014, since the records needed to measure this liability reside with the Kentucky Retirement System (KRS).

The new GASB pronouncement is required to be implemented for periods beginning after June 15, 2014. KRS has committed to providing the Credit Union with the plan measurement information needed to record the liability by December 31, 2015. The liability will be established with a charge to undivided earnings and will reduce the Credit Union's net worth ratio.

Reclassification/Presentation

Certain balances in the 2013 financial statements have been reclassified to conform to the 2014 presentation.

Subsequent Events

The financial statements and related disclosures include evaluation of events up through and including February 7, 2015, which is the date the financial statements were available to be issued.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 2 - Investment Securities

The carrying amounts of investment securities as shown in the statements of financial condition of the Credit Union and their approximate fair values at December 31, 2014 are as follows:

	2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available-for-sale:				
Federal agency securities	\$ 127,355,990	\$ 26,105	\$ (738,769)	\$ 126,643,326
Collateralized mortgage obligations	111,868,402	46,463	(2,867,938)	109,046,927
Mortgage-backed securities	23,029,042	720	(257,032)	22,772,730
Corporate bonds	8,945,022	376	-	8,945,398
Total available-for-sale	\$ 271,198,456	\$ 73,664	\$ (3,863,739)	\$ 267,408,381

The amortized cost and estimated market value of debt securities, at December 31, 2014, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to sell or prepay obligations with or without sell or prepayment penalties:

	Securities Available-for-Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$ 8,945,022	\$ 8,945,398
Due in one year to five years	121,087,068	120,464,305
Due in five to ten years	6,268,922	6,179,021
Collateralized mortgage obligations	111,868,402	109,046,927
Mortgage-backed securities	23,029,042	22,772,730
Total	\$271,198,456	\$267,408,381

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 2 - Investment Securities (Continued)

Unrealized losses as of December 31, 2014 have not been recognized into income because they are not considered to be other-than-temporary. Management considers the unrealized losses to be market driven, rather than credit driven and no losses will be realized unless the securities are sold.

Description of Securities	Continuing Unrealized Losses For Less Than 12 Months		Continuing Unrealized Losses For 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Federal agency securities	\$ 14,960,200	\$ (26,591)	\$ 98,269,691	\$ (712,178)	\$ 113,229,891	\$ (738,769)
Collateralized mortgage obligations	6,276,203	(25,916)	92,323,766	(2,842,022)	98,599,969	(2,867,938)
Mortgage-backed securities	-	-	20,903,404	(257,032)	20,903,404	(257,032)
Total	\$ 21,236,403	\$ (52,507)	\$ 211,496,861	\$ (3,811,232)	\$ 232,733,264	\$ (3,863,739)

The carrying amounts of investment securities as shown in the statements of financial condition of the Credit Union and their approximate fair values at December 31, 2013 are as follows:

	2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities available-for-sale:				
Federal agency securities	\$ 131,108,187	\$ 11,557	\$ (1,769,859)	\$ 129,349,885
Collateralized mortgage obligations	125,976,658	116,212	(4,823,489)	121,269,381
Mortgage-backed securities	27,264,994	-	(763,527)	26,501,467
Corporate bonds	8,978,392	45,266	-	9,023,658
Total available-for-sale	\$ 293,328,231	\$ 173,035	\$ (7,356,875)	\$ 286,144,391

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013**Note 3 - Loans to Members**

The composition of loans to members is as follows:

	<u>2014</u>	<u>2013</u>
Automobiles	\$ 222,184,210	\$ 177,545,655
Mortgage	218,581,950	226,872,280
Commercial	10,467,920	9,328,841
Home equity	47,837,994	45,227,378
Other secured	6,368,436	6,214,190
Unsecured	58,607,467	55,718,930
Credit card	80,991,461	70,144,631
Net deferred loan origination fees/costs	<u>1,897,235</u>	<u>936,214</u>
Total	646,936,673	591,988,119
Less: allowance for loan losses	<u>6,932,327</u>	<u>6,450,444</u>
Total loans to members	<u>\$ 640,004,346</u>	<u>\$ 585,537,675</u>

The Credit Union entered into loan participation agreements during the year ended December 31, 2014 in which a 90% interest in \$28 million of first mortgage loans was sold to two other credit unions. The loans were sold on a non-recourse basis with servicing retained by the Credit Union. The gain recognized on the sale of participation loans was \$446,547 during the year ended December 31, 2014.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Allowance for Loan Losses and Recorded Investment in Loans

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method at December 31, 2014 and 2013:

	December 31, 2014			
	Consumer	Real Estate	Commercial	Total
Allowance for loan losses:				
Beginning balance	\$ 5,074,710	\$ 190,238	\$ 1,185,496	\$ 6,450,444
Charge-offs	(6,487,199)	(186,704)	(27,500)	(6,701,403)
Recoveries	1,291,268	51,916	664,090	2,007,274
Provision	4,461,418	451,714	262,880	5,176,012
Ending balance	4,340,197	507,164	2,084,966	6,932,327
Ending balance individually evaluated for impairment	-	10,970	394,540	405,510
Ending balance collectively evaluated for impairment	<u>\$ 4,340,197</u>	<u>\$ 496,194</u>	<u>\$ 1,690,426</u>	<u>\$ 6,526,817</u>
Loans:				
Ending balance individually evaluated for impairment	\$ -	\$ 338,508	\$ 10,467,920	\$ 10,806,428
Ending balance collectively evaluated for impairment	370,048,809	266,081,436	-	636,130,245
Accrued interest receivable	<u>1,665,063</u>	<u>609,189</u>	<u>893</u>	<u>2,275,145</u>
Total recorded investment in loans	<u>\$ 371,713,872</u>	<u>\$ 267,029,133</u>	<u>\$ 10,468,813</u>	<u>\$ 649,211,818</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Allowance for Loan Losses and Recorded Investment in Loans (Continued)

	December 31, 2013			
	Consumer	Real Estate	Commercial	Total
Allowance for loan losses:				
Beginning balance	\$ 4,627,687	\$ 79,378	\$ 801,569	\$ 5,508,634
Charge-offs	(5,577,149)	(78,395)	(440,033)	(6,095,577)
Recoveries	874,063	12,572	71,340	957,975
Provision	5,150,109	176,683	752,620	6,079,412
Ending balance	5,074,710	190,238	1,185,496	6,450,444
Ending balance individually evaluated for impairment	-	-	1,185,496	1,185,496
Ending balance collectively evaluated for impairment	<u>\$ 5,074,710</u>	<u>\$ 190,238</u>	<u>\$ -</u>	<u>\$ 5,264,948</u>
Loans:				
Ending balance individually evaluated for impairment	\$ -	\$ -	\$ 2,252,928	\$ 2,252,928
Ending balance collectively evaluated for impairment	<u>310,559,618</u>	<u>272,099,658</u>	<u>7,075,913</u>	<u>589,735,189</u>
Total recorded investment in loans	<u>\$ 310,559,618</u>	<u>\$ 272,099,658</u>	<u>\$ 9,328,841</u>	<u>\$ 591,988,117</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Impaired Loans

Loan impairment is measured by estimating the expected future cash flows or by valuing the underlying collateral. The following tables present loans individually evaluated for impairment by class of loans as of December 31, 2014 and 2013:

		December 31, 2014				
		Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:						
Commercial	\$ 8,665,355	\$ 8,665,355	\$ -	\$ 9,180,532	\$ 306,726	
With an allowance recorded:						
Real estate	\$ 338,508	\$ 338,508	\$ 10,970	\$ 349,389	\$ 19,739	
Commercial	\$ 1,802,565	\$ 1,802,565	\$ 394,540	\$ 1,816,204	\$ 90,351	
Total:						
Real estate	\$ 338,508	\$ 338,508	\$ 10,970	\$ 349,389	\$ 19,739	
Commercial	\$ 10,467,920	\$ 10,467,920	\$ 394,540	\$ 10,996,736	\$ 397,077	

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Impaired Loans (Continued)

	December 31, 2013				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	\$ 481,128	\$ 481,128	\$ -	\$ 552,733	\$ 51,752
With an allowance recorded:					
Commercial	\$ 1,771,800	\$ 1,771,800	\$ 1,185,496	\$ 1,780,989	\$ 91,427
Total:					
Commercial	<u>\$ 2,252,928</u>	<u>\$ 2,252,928</u>	<u>\$ 1,185,496</u>	<u>\$ 2,333,722</u>	<u>\$ 143,179</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Credit Quality Indicators

The Credit Union categorizes member business loans into risk categories based on relevant information about the ability of the borrower to service their debts such as current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Credit Union analyzes member business loans individually by classifying the loans as to credit risk. This analysis is limited to member business loans. The Credit Union uses the following definitions for classified risk rating:

Special Mention - A Special Mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the obligor's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Substandard - A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful - An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013**Note 3 - Loans to Members (Continued)**Credit Quality Indicators (Continued)

Loans not meeting the criteria on the previous page that are analyzed individually as part of the previously described process are considered to be prime or pass rated loans. At December 31, 2014 and 2013, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

		December 31, 2014				
		Pass	Special Mention	Substandard	Doubtful	Total
Commercial		<u>\$ 9,345,791</u>	<u>\$ -</u>	<u>\$ 449,304</u>	<u>\$ 673,718</u>	<u>\$ 10,468,813</u>
		December 31, 2013				
		Pass	Special Mention	Substandard	Doubtful	Total
Commercial		<u>\$ 7,075,912</u>	<u>\$ 365,118</u>	<u>\$ 627,288</u>	<u>\$ 1,200,523</u>	<u>\$ 9,328,841</u>

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Credit Quality Indicators (Continued)

The Credit Union considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Credit Union also evaluates credit quality based on the aging status of the loan, which was previously presented and by payment activity. The following tables present the recorded investment in residential and consumer loans based on payment activity as of December 31, 2014 and 2013:

		December 31, 2014					
	Direct Automobile	Indirect Automobile	Unsecured Credit		Other Secured	First/Second Mortgage	Totals
			Personal	Cards			
Performing	\$ 84,317,200	\$ 118,461,708	\$ 58,043,586	\$ 81,308,029	\$ 6,612,699	\$ 217,855,964	\$ 614,096,237
Non-performing	512,385	854,973	496,407	360,750	33,744	1,283,817	3,746,768
Total	\$ 85,229,785	\$ 119,346,682	\$ 58,542,083	\$ 81,728,879	\$ 6,646,443	\$ 219,139,781	\$ 618,743,005

		December 31, 2013					
	Direct Automobile	Indirect Automobile	Unsecured Credit		Other Secured	First/Second Mortgage	Totals
			Personal	Cards			
Performing	\$ 70,135,407	\$ 97,427,024	\$ 55,308,047	\$ 69,245,136	\$ 6,741,020	\$ 225,599,342	\$ 578,543,197
Non-performing	623,334	1,273,255	352,926	260,464	110,100	1,272,840	4,116,179
Total	\$ 70,758,641	\$ 98,700,279	\$ 55,741,873	\$ 69,505,600	\$ 6,851,219	\$ 226,872,282	\$ 582,659,276

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COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 3 - Loans to Members (Continued)

Age Analysis of Past Due Loans

The following tables present the aging of the recorded investment in past due loans at December 31, 2014 and 2013:

	December 31, 2014					Recorded Investment in Past Due Loans and Accruing
	10-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	
Direct automobile	\$ 1,015,422	\$ 351,147	\$ 912,585	\$ 1,879,154	\$ 80,350,631	\$ 85,229,785
Indirect automobile	2,491,866	981,941	884,973	4,357,980	134,983,702	139,346,682
Unsecured personal	311,683	265,685	496,497	1,273,865	57,268,238	58,542,083
Unsecured credit cards	331,199	117,262	360,250	829,011	80,919,868	81,748,879
Other secured	24,108	32,359	33,744	90,241	6,756,202	6,846,443
First second mortgage	1,198,245	215,758	1,281,817	2,697,820	216,441,961	219,139,781
HELOC	81,106	37,824	174,902	293,832	47,595,726	47,889,552
Commercial	-	-	122,532	122,532	10,346,281	10,468,811
Total	\$ 5,652,923	\$ 2,027,086	\$ 3,869,300	\$ 11,549,309	\$ 637,662,609	\$ 649,211,818

	December 31, 2013					Recorded Investment in Past Due Loans and Accruing
	10-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	
Direct automobile	\$ 912,290	\$ 310,647	\$ 623,338	\$ 1,846,275	\$ 77,872,370	\$ 79,718,645
Indirect automobile	2,669,220	588,230	1,273,255	4,530,705	94,169,574	98,700,279
Unsecured personal	493,775	204,023	352,926	1,050,724	54,691,149	55,741,873
Unsecured credit cards	450,464	229,641	260,464	940,569	68,574,011	69,505,600
Other secured	114,636	7,794	110,199	232,629	6,620,590	6,853,219
First second mortgage	1,437,606	249,112	1,272,840	2,959,558	223,912,724	226,872,282
HELOC	98,397	87,146	223,157	408,702	44,818,676	45,227,378
Commercial	679,423	370,556	1,390,501	2,440,480	6,888,361	9,328,841
Total	\$ 6,866,831	\$ 2,055,151	\$ 5,515,089	\$ 14,437,071	\$ 577,547,455	\$ 591,988,117

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COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013**Note 3 - Loans to Members (Continued)**

Troubled Debt Restructurings

The following tables present modified loans by class of loans which were troubled debt restructurings as of December 31, 2014 and 2013:

	2014			2013		
	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment	Number of Contracts	Pre- Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Troubled debt restructurings:						
Consumer	-	\$ -	\$ -	-	\$ -	\$ -
First/second mortgage	-	-	-	-	-	-
Commercial	1	458,840	458,840	1	467,501	507,501
			2014		2013	
		Number of Contracts	Charged-off Amount	Number of Contracts	Charged-off Amount	
Troubled debt restructurings that subsequently defaulted:						
Consumer	-	\$ -	\$ -	-	\$ -	\$ -
First/second mortgage	-	-	-	-	-	-
Commercial	1	-	-	2	-	735,674

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COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 4 - Property and Equipment

The principal categories of property and equipment may be summarized as of December 31, 2014 and 2013 as follows:

	<u>2014</u>	<u>2013</u>
Land and improvements	\$ 5,979,022	\$ 5,086,080
Building and improvements	29,741,969	28,351,543
Furniture and equipment	10,488,944	9,343,930
Computer equipment	<u>2,928,267</u>	<u>2,939,821</u>
Total cost	49,138,202	45,721,374
Less accumulated depreciation	<u>22,730,969</u>	<u>21,609,960</u>
Undepreciated cost	<u>\$ 26,407,233</u>	<u>\$ 24,111,414</u>

Note 5 - Borrowed Funds

The Credit Union has a line-of-credit available from Volunteer Corporate Federal Credit Union at a variable rate of interest, guaranteed by all assets, maximum credit available of \$10,000,000 at December 31, 2014 and 2013. There were no funds borrowed under the line-of-credit outstanding at December 31, 2014 and 2013.

The Credit Union has also established borrowing facilities with the Federal Reserve, Federal Home Loan Bank of Cincinnati, and PNC Bank. These facilities do not represent committed lines-of-credit and are subject to the approval of each bank. The Credit Union did not borrow against these facilities and had no balance payable as of December 31, 2014 and 2013.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 6 - Members' Shares and Savings Accounts

	<u>2014</u>	<u>2013</u>
Share accounts	\$ 380,093,228	\$ 355,024,591
Individual retirement accounts	20,441,730	21,362,377
Share draft accounts	109,921,572	96,189,112
Money market accounts	91,748,983	94,234,533
Certificates of deposit and IRA certificates	<u>177,993,747</u>	<u>189,389,233</u>
Total	<u>\$ 780,199,260</u>	<u>\$ 756,199,846</u>

At December 31, 2014, scheduled maturities of certificates of deposit and IRA certificates are as follows:

2015	\$ 113,659,981
2016	34,874,266
2017	12,491,943
2018	9,359,529
2019	6,688,880
Thereafter	<u>919,148</u>
Total	<u>\$ 177,993,747</u>

Interest expense on members' share accounts is summarized as follows:

	<u>2014</u>	<u>2013</u>
Share accounts	\$ 552,227	\$ 510,159
Individual retirement accounts	38,161	36,422
Share draft accounts	93,360	85,715
Money market accounts	161,722	171,468
Certificates of deposit and IRA certificates	<u>2,037,425</u>	<u>2,407,733</u>
Total	<u>\$ 2,882,895</u>	<u>\$ 3,211,497</u>

The aggregate amount of time deposit accounts in denominations of \$100,000 or more at December 31, 2014 were approximately \$45,700,000.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 7 - Members' Equity

Regulatory Capital

The Credit Union is subject to various regulatory capital requirements administered by its primary federal regulator, the NCUA. Failure to meet the minimum regulatory capital requirements can initiate certain mandatory, and possible additional discretionary actions by regulators, that if undertaken, could have a direct material effect on the Credit Union's financial statements. Under the regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, the Credit Union must meet specific capital guidelines involving quantitative measures of the Credit Union's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Credit Union's capital amounts and net worth classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Credit Union to maintain minimum amounts and ratios of net worth to total assets. Credit unions are also required to calculate a Risk-Based Net Worth Requirement (RBNWR) which establishes whether or not a credit union will be considered complex under the regulatory framework. The Credit Union's RBNWR ratio as of December 31, 2014 and 2013 was 6.08% and 6.53%, respectively. The minimum ratio to be considered complex under the regulatory framework is 6.0%. Management believes as of December 31, 2014 and 2013, that the Credit Union meets all capital adequacy requirements to which it is subject.

As of December 31, 2014 and 2013, the Credit Union was categorized as well capitalized under the regulatory framework for prompt corrective action.

	Actual		To Be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio
December 31, 2014				
Net worth	\$ 192,234,000	19.63%	\$ 68,544,305	7.00%
December 31, 2013				
Net worth	\$ 184,279,459	19.52%	\$ 66,078,414	7.00%

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 8 - Related Party Transactions

The majority of employees and all members of the Board of Directors have member accounts at the Credit Union, including share, deposit and loan accounts. The terms of transactions involving these accounts (i.e., rates charged and paid) are comparable to other members.

Included in loans receivable at December 31, 2014 and 2013 are loans of \$1,889,449 and \$1,217,090, respectively, to directors and executive officers of the Credit Union. Such loans are made in the ordinary course of business at normal credit terms including interest rates and collateralization.

Note 9 - Commitments and Contingent Liabilities

The principal commitments of the Credit Union are as follows:

Loan Commitments

At December 31, 2014, the Credit Union had outstanding commitments for unused lines-of-credit that are not reflected in the accompanying financial statements, as follows:

Business loans	\$ 2,000,000
Construction loans	1,594,219
Home equity	56,807,019
Overdraft protection	613,489
Lines-of-credit	38,210,280
Credit cards	<u>143,536,134</u>
Total	<u>\$ 242,761,141</u>

The Credit Union is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its members and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the statements of financial condition. The contract or notional amounts of those instruments reflect the extent of involvement the Credit Union has in particular classes of financial instruments.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 9 - Commitments and Contingent Liabilities (Continued)

The Credit Union's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual notional amount of those instruments. The Credit Union uses the same credit policies in making commitments as it does for on-balance sheet instruments.

Financial instruments whose contract amounts represent credit risk:

Commitments to extend credit, generally unsecured	\$ 182,359,903
Commitments to extend credit, secured	<u>60,401,238</u>
Total	<u>\$ 242,761,141</u>

Commitments to extend credit are agreements to lend to a member as long as there is no violation of any condition established in the contract. Commitments generally have termination clauses or fixed expiration dates. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Credit Union evaluates each member's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Credit Union upon extension of credit, is based on management's credit evaluation of the member and classification of loan.

Note 10 - Fair Values of Financial Instruments

The Credit Union uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted prices for the Credit Union's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value of other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of a financial instrument.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 10 - Fair Values of Financial Instruments (Continued)

The definition of fair value focuses on exit price in an orderly transaction between market participants at the measurement date under current market conditions, other than in a forced liquidation or distressed sale. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in the valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

The following methods and assumptions were used by the Credit Union in estimating fair value disclosures for the financial statements:

Cash and Cash Equivalents/Non-Negotiable Certificates of Deposit

The carrying amount approximates fair value due to the short-term nature of these instruments.

Investment Securities

Fair values have been determined using significant observable inputs for all investment securities.

Loans Receivable

Fair value is based on the discounted value of future cash flows expected to be received for a loan or group of loans using current rates at which similar loans would be made to borrowers with similar credit ratings and the same remaining maturities. This method considers interest rate changes and credit risk changes within the discount rate chosen. A single discount rate is applied to homogeneous categories of loans such as credit cards and automobile loans.

Members' Shares and Savings Accounts

The fair value of member deposits (savings accounts, share drafts, and deposit accounts) having no fixed maturity is the amount payable on demand at the reporting date.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 10 - Fair Values of Financial Instruments (Continued)

Certificate of Deposit Accounts

The fair value of fixed maturity certificates of deposit and IRA certificates is estimated using the rates currently offered for deposits with similar remaining maturities.

Commitments to Extend Credit

The estimate of fair value of the commitments to extend credit represents the Credit Union's potentially unfunded commitments under such lines-of-credit.

The carrying amounts and estimated fair values of the Credit Union's financial instruments at December 31, 2014 and 2013, are as follows:

	<u>2014</u>		<u>2013</u>	
	<u>Carrying Amounts</u>	<u>Fair Value</u>	<u>Carrying Amounts</u>	<u>Fair Value</u>
Financial assets:				
Cash and cash equivalents	\$ 21,658,062	\$ 21,658,062	\$ 24,899,993	\$ 24,899,993
Non-negotiable certificates of deposit	4,216,000	4,216,000	5,416,000	5,416,000
Investment securities	267,408,381	267,408,381	286,144,391	286,144,391
Loans receivable, net of allowance for loan losses	640,004,346	641,982,395	585,537,675	582,569,475
	<u>\$ 933,286,789</u>	<u>\$ 935,264,838</u>	<u>\$ 901,998,059</u>	<u>\$ 899,029,859</u>
Financial liabilities:				
Members' shares and savings accounts	\$ 780,199,260	\$ 775,281,660	\$ 756,199,846	\$ 750,637,911
Unrecognized financial instruments:				
Commitments to extend credit	\$ -	\$ 242,761,141	\$ -	\$ 255,820,961

COMMONWEALTH CREDIT UNION**NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013**

Note 11 - Fair Value Measurements

Accounting standards require certain assets and liabilities be reported at fair value in the financial statements and provide a framework for establishing that fair value. The framework for determining fair value is based on a hierarchy that prioritizes the inputs and valuation techniques used to measure fair value.

The following table presents information about the Credit Union's assets measured at fair value on a recurring basis at December 31, 2014 and 2013 and the valuation techniques used by the Credit Union to determine those fair values. The three levels of the fair value hierarchy are described below:

Basis of Fair Value Measurements

- Level 1 - Valuation is based on quoted market prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 - Valuation is based on inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
- Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined by using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 11 - Fair Value Measurements (Continued)

Assets Measured at Fair Value on a Recurring Basis

Assets measured at fair value on a recurring basis at December 31, 2014 and 2013 are summarized as follows:

	Fair Value Measurements at December 31, 2014, Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Available-for-sale securities	\$ -	\$ 267,408,381	\$ -	\$ 267,408,381

	Fair Value Measurements at December 31, 2013, Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Available-for-sale securities	\$ -	\$ 286,144,391	\$ -	\$ 286,144,391

Valuation Methods for Instruments Measured at Fair Value on a Non-Recurring Basis

The following is a description of the Credit Union's valuation methodologies used for assets and liabilities recorded at fair value on a non-recurring basis:

Impaired Loans

The Credit Union does not record loans at fair value on a recurring basis. However, on occasion, a loan is considered impaired and an allowance for loan loss is established. A loan is considered impaired when it is probable that all of the principal and interest under the original terms of the loan may not be collected. Once a loan is identified as individually impaired, management measures the impairment in accordance with the criteria described in Note 1. Impaired loans where an allowance is established based on fair value of collateral require classification in the fair value hierarchy. When fair value of the collateral is based on an observable market price or current appraised value, the Credit Union records the impaired loans as non-recurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Credit Union records the impairment value as non-recurring Level 3.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2014 AND 2013

Note 11 - Fair Value Measurements (Continued)

Valuation Methods for Instruments Measured at Fair Value on a Non-Recurring Basis (Continued)Other Real Estate Owned

Other real estate owned assets are reported in the following non-recurring table at initial recognition of impairment and on an ongoing basis until recovery or charge-off. At the time of foreclosure or repossession, real estate owned and repossessed assets are adjusted to their fair value less costs to sell upon transfer of the loans to real estate owned and repossessed assets, establishing a new cost basis. At that time, they are reported in the Credit Union's fair value disclosures in the following non-recurring table.

Assets Measured at Fair Value on a Non-Recurring Basis

Fair Value Measurements at December 31, 2014, Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Impaired loans	\$ -	\$ 1,735,563	\$ -	\$ 1,735,563
Other real estate owned	-	716,507	-	716,507
Total	\$ -	\$ 2,452,070	\$ -	\$ 2,452,070

Fair Value Measurements at December 31, 2013, Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Carrying Value
Impaired loans	\$ -	\$ 1,067,432	\$ -	\$ 1,067,432
Other real estate owned	-	597,453	-	597,453
Total	\$ -	\$ 1,664,885	\$ -	\$ 1,664,885

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 12 - Defined Benefit Pension Plan and Postemployment Benefits

Plan Description

The Credit Union participates in the Kentucky Employees' Retirement System (KERS), which is a cost-sharing multiple-employer defined benefit pension plan that covers substantially all regular full-time Credit Union employees. The plan provides for retirement, disability, and death benefits to plan members. Retirement benefits may be extended to beneficiaries of plan members under certain circumstances.

This system is one of three systems administered under one administrative agency known as the Kentucky Retirement System (KRS). The KRS issues a publicly available financial report that includes financial statements and required supplementary information for each system it administers. That report may be obtained online. The most recent annual report is as of June 30, 2014.

Actuarial Funding

KRS administers both a pension fund and an insurance fund for each of the systems it manages. These trusts are used to fund monthly pension and health care payments to and on behalf of retirees. Non-hazardous (Credit Union employees are within this classification) employees are statutorily required to contribute 5% of pre-tax salary to their pension benefit. All employees hired with an initial participation date on or after September 1, 2008 must contribute an additional 1% of their pre-tax compensation toward their retiree health insurance benefits. These monies are deposited in a 401(h) account within the pension trust. Employer contributions are calculated annually by the Board of Trustees and include the normal cost of pension and insurance benefits plus a contribution toward the unfunded liability of the pension and insurance trusts designed to amortize that liability over a period no longer than 30 years. Employer contributions also include an administrative fee that is used to pay annual operating expenses of KRS. The administrative expense is shared among the plans based on the ratio of a plan's membership to the total system membership at the beginning of a fiscal year.

As of June 30, 2014 (the date of the most recent KERS comprehensive annual financial report), the funded ratio of the KERS nonhazardous pension plan is 21.00% of the actuarial value of assets.

The Credit Union's contributions to the KERS plan for the years ended December 31, 2014 and 2013 were approximately \$4,098,000 and \$2,953,000, respectively.

COMMONWEALTH CREDIT UNION

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 2014 AND 2013

Note 12 - Defined Benefit Pension Plan and Postemployment Benefits (Continued)

Actuarial Funding (Continued)

The Credit Union makes a contribution, which includes both insurance and pension to the KERS for employees. The contribution rate was 26.79% for the period from January 1, 2014 through December 31, 2014 and 25.20% for the period from January 1, 2013 through December 31, 2013.

Postemployment Benefits

Participation in the insurance program is optional and requires the completion of the proper forms at the time of retirement in order to obtain the insurance coverage. The KERS provides access to health insurance coverage through the Kentucky Employees Group Health Plan (KEHP) for recipients until they reach age 65 and/or become Medicare eligible. After a retired member becomes eligible for Medicare, coverage is available through a Medicare eligible plan offered by the KERS. A retired member's spouse and/or dependents may also be covered on health insurance through the KERS. Required contributions for postemployment health care benefits are included as part of the Credit Union's total contribution to the KERS plan discussed above.

* * * End of Notes * * *

UNITED STATES OF AMERICA

157748

Commonwealth of Kentucky

Department of State



Office of Secretary of State

GEORGE GLENN HATCHER, SECRETARY

CERTIFICATE FOR NON-STOCK CORPORATION

I, George Glenn Hatcher, Secretary of State, do hereby certify that the Articles of Incorporation in triplicate originals of COMMONWEALTH CREDIT UNION, INC.

(Frankfort, Kentucky)

are found to be duly signed and acknowledged; that there appears to be no capital stock; no private pecuniary profit is to be derived therefrom; no organization tax is required by law; all fees and charges have been paid; that one original copy is filed and recorded in this office. It further appears that all requirements of law have been complied with and this certificate, with two original articles of incorporation indorsed with the fact and time of recording in this office, has been returned to the incorporators or their representative. Corporate existence shall begin upon the issuance of this certificate. Said certificate shall be conclusive evidence of the fact that the above named corporation has been incorporated and is now authorized and empowered to do business in Kentucky, subject to the restrictions imposed by Chapter 273, Kentucky Revised Statutes, and other laws.



Given under my official signature and seal

this the 2nd day of April 19 51

George Glenn Hatcher
SECRETARY OF STATE

By _____
Deputy, Corporation Department.

SECRETARY OF STATE

4/2/51 Original Process Agent: Jack T. Page, Frankfort, Ky.

D-4249

ARTICLES OF INCORPORATION
(and Articles of Agreement)

Commonwealth Credit Union

We, the undersigned, residents of the State of Kentucky and officers and employees of the Departments, Finance, Revenue, and Highways, Commonwealth of Kentucky, do hereby apply for permission to organize a Credit Union and do enter into these Articles of Agreement and do hereby bind ourselves to comply with these Articles of Incorporation and will all laws, rules and regulations applicable to Credit Unions in Kentucky; and hereby certify as follows:

- (1) The name of the proposed Credit Union is the Commonwealth Credit Union, Inc.
- (2) This incorporation is desired in accordance with the provisions of Chapter 10 of the Acts of the 1922 of the General Assembly of the State of Kentucky, as amended by the General Assembly in 1940 and 1946, entitled: "An Act to Provide for the Establishment and Operation of Credit Unions in the Commonwealth of Kentucky."
- (3) The par value of the shares shall be five dollars (\$5.00) per share.
Jack T. Page, Frankfort, Kentucky is designated Process Agent.
- (4) The principal office of the Credit Union shall be in Frankfort, Kentucky.
- (5) The names and addresses of the subscribers to these Articles of Incorporation and the number of shares subscribed by each are as follows:

Name and Address	Shares Subscribed
1. <u>Pierce Hutton Forks of Elkhorn, Ky.</u>	<u>3</u>
2. <u>Charles B. Boyd Frankfort, Ky.</u>	<u>2</u>
3. <u>Weldon Jones Frankfort, Ky.</u>	<u>3</u>
4. <u>E. R. Robinson Frankfort, Ky.</u>	<u>5</u>
5. <u>J. D. Kelly Frankfort</u>	<u>17 shares</u>
6. <u>James A. Tyler Frankfort</u>	<u>4 shares</u>
7. <u>Harold S. Moore - Box 104, Shelbyville</u>	<u>3 shares</u>
8. <u>William B. Wickenman - Route 4, Frankfort</u>	<u>3 shares</u>

IN WITNESS WHEREOF, we have made, signed and acknowledged these Articles of incorporation and Articles of Agreement, in triplicate this ____ day of ____ 19__.

Name	Address
1. <u>Pierce Hutton</u>	<u>Forks of Elkhorn, Ky.</u>
2. <u>Charles B. Boyd</u>	<u>Frankfort, Ky.</u>
3. <u>Weldon Jones</u>	<u>Frankfort, Ky.</u>
4. <u>E. R. Robinson</u>	<u>Frankfort 5</u>
5. <u>J. D. Kelly</u>	<u>Frankfort</u>
6. <u>James A. Tyler</u>	<u>Frankfort</u>
7. <u>Harold S. Moore</u>	<u>P.O. Box 104, Shelbyville, Ky.</u>
8. <u>William B. Wickenman</u>	<u>Route #4, Frankfort, Ky.</u>

EXAMINED AND APPROVED 4-2-51
DEPARTMENT OF BANKING, STATE OF KENTUCKY
H. H. Carter
H. H. CARTER
Commissioner

STATE OF KENTUCKY } ss
COUNTY OF FRANKLIN }

Before me, the undersigned, a Notary Public in and for said County and State of Kentucky, personally appeared the above named parties, and severally acknowledged the foregoing Articles of Incorporation and Articles of Agreement. Witness my hand and notarial seal this 12 day of March 1951.

One. Harrison Paul
Notary Public Franklin Co.
My Commission expires 2/1/52

ORIGINAL COPY
FILED AND RECORDED

DATE APR 2 1951

George H. Lewis
SECRETARY OF STATE OF KENTUCKY
FRANKFORT, KENTUCKY
BY [Signature] DEPUTY

National Credit Union Administration

Report of Officials

Commonwealth Credit Union Charter 61437
Check Digit 2625

Charter Number:	61437	Report Date:	1/31/14
Credit Union Name:	Commonwealth Credit Union		
Annual Meeting Date:	January 22, 2015		
Mailing Address:	P.O. Box 978 Frankfort, KY 40602-0978		
Days Open:	Monday-Friday	Office Hours:	9:00-5:00
Phone:	(502) 564-4775	Fax:	(502) 564-8146
Office Location:	417 High Street Frankfort, KY 40601	County:	Franklin
Manager (CEO):	Karen Harbin—Full time		
Credit Union's Organizational E-mail address:	www.ccuky.org		

Board of Directors:

Name:	Rose, Alex W	Title:	Chairperson
Address:	948 Moss Lane Frankfort, KY 40601		
Home Phone:	(502) 875-5262	Work Phone:	N/A
Email:	alexroseck@fewpb.net		

Name:	Grubbs, Regina	Title:	Vice-Chairperson
Address:	68 Lantern Way Nicholasville, KY 40356		
Home Phone:	(859) 223-5412	Work Phone:	N/A
Email:	reggrubbs@twc.com		

Name:	Chadwell Jr, James C.	Title:	Secretary/Treasurer
Address:	142 Brentlawn Drive Frankfort, KY 40601		
Home Phone:	(502) 223-4919	Work Phone:	N/A
Email:	jchadwell@fewpb.net		

Name:	Blackwell, Kenneth	Title:	Board Member
Address:	119 Oxford Place Frankfort, KY 40601		
Home Phone:	(502) 229-4899	Work Phone:	(502) 229-4899
Email:	kblackwell@harrodassociates.com		

Name:	Brewer, Robin	Title:	Board Member
Address:	1104 Collins Lane Apt. 5 Frankfort, KY 40601		
Home Phone:	(859) 582-7400	Work Phone:	(502) 564-4550
Email:	robin.brewer@ky.gov		

National Credit Union Administration

Report of Officials

Commonwealth Credit Union Charter 61437
Check Digit 2625

Name:	Fawns, Thomas R.	Title:	Board member
Address:	159 Plantation Drive Shelbyville, KY 40065		
Home Phone:	(502) 220-2115	Work Phone:	
Email:	randy.fawns@gmail.com		

Name:	Foster, Mary K.	Title:	Board member
Address:	206 Tonkawa Trail Frankfort, KY 40601		
Home Phone:	(502) 695-2858	Work Phone:	N/A
Email:	mkfosterky@yahoo.com		

Name:	Jones, Kay L.	Title:	Board member
Address:	749 Winterhaven Lane Frankfort, KY 40601		
Home Phone:	(502) 695-4621	Work Phone:	N/A
Email:	kykay@fewpb.net		

Name:	Leach, Williams H.	Title:	Board member
Address:	P.O. Box 1176 Frankfort, KY 40602		
Home Phone:	(502) 803-6022	Work Phone:	N/A
Email:	wleach01@icloud.com		

Name:	Overstreet, Randy J.	Title:	Board member
Address:	115 Fox Ridge Road Bardstown, KY 40004		
Home Phone:	(270) 234-0039	Work Phone:	N/A
Email:	roverstreet@bardstowncable.net		

Name:	Suter, Harry	Title:	Board member
Address:	1123 Deer Haven Dr. Frankfort, KY 40601		
Home Phone:	(502) 695-5628	Work Phone:	N/A
Email:	harleete1@aol.com		

Name:	Karen C. Harbin	Title:	President/CEO
Address:	10 Belmont Frankfort, KY 40601		
Home Phone:	(502) 695-7172	Work Phone:	(502) 564-5564
Email:	kharbin@cwcu.org		

Bylaws of Commonwealth Credit Union

Article I

Purposes

Section 1. The name of this Credit Union shall be as stated in Section 1 of the Articles of Incorporation.

Section 2. The purposes of this Credit Union are to promote thrift among its members and to make loans to its members, and to do and perform such services and acts and have and exercise such powers as are granted and allowed credit unions provided in Chapter 290 of the Kentucky Revised Statutes, approved and in force, as now or hereafter amended.

Article II

Membership

Section 1. The field of membership of this Credit Union is limited to: members of the Kentucky Employees Retirement System, Teachers Retirement System, County Employees Retirement System, State Police Retirement System, employees of the Commonwealth of Kentucky, including the legislative, judicial, and executive branches, employees of the Credit Union;

Employees in the field of education, including colleges, universities and trade schools;

Employees of any city or county governments and any political subdivisions of said governments;

Any other employees of the previously mentioned groups that may be made eligible to membership by the Board of Directors; pensioners; annuitants and unremarried spouses of persons who died while in the field of membership; members of their respective immediate families; and organizations of such member groups.

"Immediate family" as used in Section 1 is defined to mean spouse, children, brother, sister, mother, father, grandchildren, grandmother, grandfather, anyone related by blood or marriage and/or any other dependents of which the member has legal custody.

Section 2. Membership is determined by election to membership as provided in Chapter 290 of the Kentucky Revised Statutes, approved and in force, as of now or hereafter amended.

Section 3. Members who leave the field of membership may retain their membership by standards established by the Board of Directors and maintained for in the office of the Credit Union.

Article III

Meetings of Members

Section 1. The annual meeting of the members shall be held at such time and place as the Board of Directors shall determine. A notice of said annual meeting shall be mailed or given to each member, or posted in a conspicuous place in the office of the Credit Union by the Secretary at least ten days before the date thereof..

Section 2. Fifteen members shall constitute a quorum. If a quorum is not present on the date first appointed for a regular or special meeting of the Credit Union, the meeting shall be adjourned for ten days, and a second notice shall be provided to all members, containing the date of the adjourned meeting, at which said adjourned meeting those then present shall constitute a quorum for the transaction of business.

Section 3. Each member shall have but one vote, irrespective of the number of shares he may own. When not otherwise provided, the vote of the majority of the members present in person at a meeting shall be the act of the Corporation. A member other than a natural person shall be entitled to one vote to be cast by a duly delegated agent.

Section 4. The Board of Directors of the Credit Union or the Supervisory Committee may call special meetings of the Credit Union, and special meetings shall be held upon request, in writing, of ten percent of the members. All notices of special meeting shall state clearly the purpose of the call for the meeting and, at said meeting, no other business shall be transacted, except as set forth in the call. Notices of all meetings shall be provided to each member at least ten days before the date of the meeting.

Section 5. There shall be no more than three directors at any one time on the Board from any one Cabinet or Employer Group unless a transfer is made after Board election.

Section 6. At least ninety (90) days prior to each annual meeting, the Chairman of the Board shall appoint a Nominating Committee of three (3) members. It shall be the duty of the Nominating Committee to nominate at least one member for each vacancy for which elections are being held at the Annual Meeting, and file its nominations with the Secretary of the Credit Union by December 1st and the Secretary shall cause such nominations to be posted in a conspicuous place at all Credit Union branch locations in the Credit Union office at least thirty (30) days prior to the Annual Meeting. Prior to filing such nominations with the Secretary, the Nominating Committee shall determine that the members nominated are agreeable to the placing of their names in nomination and will accept office if elected.

Those members not nominated by the Nominating Committee shall be notified by the committee of its decision and may cause their name to be added to the ballot by submitting, on or before December 1st, a petition signed by themselves and at least 25 other members. To be effective, such petition shall be accompanied by a certificate from the petitioner stating that they will serve if elected to office.

The Nominating Committee and the Secretary shall submit reports in December to the Commonwealth Credit Union Board of Directors for approval finalizing the ballot. The Secretary shall cause the names of the nominees and petitioners to be posted in a conspicuous place at all Credit Union branch locations at least thirty (30) days prior to the Annual Meeting.

The Secretary shall not accept petitions received by or on behalf of former paid credit union Associates for a period of three (3) years from the last date of employment. Further, former paid credit union Associates shall not be nominated by the Nominating Committee nor serve on the Commonwealth Credit Union Board of Directors in any capacity for a period of three (3) years from the last date of employment. At the expiration of the three (3) year

period, former paid Associates may petition the Secretary, may be nominated by the Nominating Committee, and may serve on the Commonwealth Credit Union Board of Directors.

Section 7. A member is not eligible to serve on the Commonwealth Credit Union Board of Directors, or Supervisory Committee while serving as a Board member, employee or in any other capacity at another financial institution.

The President of the credit union may be a director and a paid employee of the credit union. No other director and no committee member may be a paid employee of the credit union. No former paid credit union Associate may serve on any Commonwealth Credit Union committee in any capacity for a period of three (3) years from the last date of employment. No family member (spouse, children, grandchildren, parents, step-parent, step-children, siblings, step-siblings, and in-laws) of a director or committee member may be a paid employee of the credit union. A serving board or committee member that becomes related (as defined above) to a paid employee of the credit union shall resign immediately from the board or committee if the related paid employee does not resign.

All elections shall be by ballot. If any or all persons on the ballot are uncontested, their election may be by voice vote.

The minimum age of eighteen (18) is a qualification for eligibility to vote at meetings of members of this Credit Union; and the minimum age of eighteen (18) is a qualification to hold elective and/or appointive office in this Credit Union.

Article IV

Terms of Office

Board of Directors

The Board shall be made up of thirteen directors. Regular terms of office for elected directors shall be for periods of four years. The term of newly elected board members will begin one week from the date of the election.

Supervisory Committee

The Supervisory Committee shall be made up of five members. The terms of office shall be for three years. Each year the Board shall appoint members to fill expired terms.

Indemnity of Officials and Employees

Section 1. The credit union shall indemnify, to the extent permitted by law, current and former officials and employees of the credit union for any claims, losses, and liability asserted against or incurred by them, including reasonable legal fees and related costs, in connection with court or administrative proceedings to which they are or may become parties, by reason of or arising from their performance of official duties and responsibilities on behalf of the credit union; except, the credit union shall not provide indemnification for any such claims, liability, and losses resulting from fraud, conviction of a crime in any proceeding, or willful misconduct of an official or employee.

Section 2. The credit union may purchase and maintain insurance on behalf of the individuals indicated in Section 1 above against any liability asserted against them and expenses reasonably incurred by them in their official capacities and arising out of the performance of their official duties to the extent such insurance is permitted by the applicable Kentucky laws.

Section 3. The term "official" in this bylaw means a person who is a member of the Board of Directors, Supervisory Committee, other volunteer committee (including elected or appointed loan officers or membership officers), established by the Board of Directors.

Article V

Duties of Officers

Section 1. The officers of this Credit Union shall be as defined in the Credit Union Act.

Section 2. The duties of the Chairman of the Board shall be to preside at meetings of the members and the Board of Directors, and to perform all other usual duties connected with that office.

Section 3. The Vice Chairman shall, in the absence of the Chairman, perform the duties of the Chairman and such other duties as the Board of Directors may from time to time prescribe.

Section 4. The Treasurer shall be responsible for submitting financial reports to the supervisory agencies and may serve as the Process Agent.

Section 5. The Secretary shall keep records of all meetings of the members and the Board of Directors. He shall give notice of all meetings of members, and shall perform all other duties incident to his office.

Section 6. The President shall be the General Manager of the Credit Union and be in active charge of its operations.

Article VI

Forms of Shares and Notices of Withdrawals

Section 1. The number of shares which may be issued by this Credit Union shall be unlimited and in such form as prescribed by the Credit Union Act and approved by the Commissioner of Banking.

Section 2. The par value of shares shall be determined by the Board of Directors.

Section 3. The Board may establish a required fee for membership and will maintain such information in the office of the Credit Union.

Section 4. Full paid shares may be transferred to any person eligible to membership.

Section 5. A member may withdraw his money paid in on shares on any day when payments for shares may be received, provided the withdrawing member has filed a written notice of such intention; but the Board of Directors may require a member, at any time, to give thirty days notice, of his intention to withdraw the whole or any part of the amount paid in by him on account of shares.

Such withdrawing member shall receive the amount paid in by him on account of shares, together with such dividends as have been credited thereto, less any lawful fines or other obligations due to this Credit Union. Withdrawals shall be met in the order of their filing, and as funds therefore become available. No member who has filed a notice of his intention shall exercise any of the privileges of membership, except the Board may establish a

special class of shares not withdrawable, redeemable or transferable except upon termination of membership in the Credit Union.

Section 6. No officer, director or committee member shall discount or directly or indirectly purchase from another member a share in this Credit Union, whether filed for withdrawal or not.

Section 7. The Credit Union shall have a lien on the shares of any members and upon the dividends payable thereon, for and to the extent of any loans made to him, or any dues and fines payable by him.

Section 8. Upon direction by the member, shares may be paid to a third party.

Section 9. Share Certificates may be issued on condition that the certificate program is in compliance with the National Credit Union Administration Rules and Regulations 701.35,

Section 10. Money Market Certificates may be issued on condition that the certificate program is in compliance with the National Credit Union Administration Rules and Regulations 701.35.

Section 11. Share Drafts may be issued on condition that the share draft program is in compliance with National Credit Union Administration Rules and Regulations 701.34.

Section 12. Individual Retirement Accounts and Keogh Accounts may be issued on condition that these accounts are in compliance with National Credit Union Administration Rules and Regulations 721.4 and 401(d) or 408 of the Internal Revenue Code.

Article VII

Fines

Unless waived by the Board of Directors, a member failing to make a payment upon shares when due, or on repayments of a loan when due, shall pay a fine at a rate fixed by the Board.

Article VIII

Loans

Section 1. Except as otherwise provided in the laws and regulations governing credit unions, loans shall be made only to members.

Section 2. No loan shall be made to any member in excess of the limitations imposed by the Credit Union Act.

Section 3. The amount of a loan, the time for which it is granted, the terms of its repayment and the form and value of the security, if any, shall be determined by the policy limitations established by the Board of Directors.

Section 4. The rate of interest charged on loans and policies with respect to the granting of loans shall be fixed by the Board of Directors.

Section 5. Applications for loans shall state the purpose for which the money is borrowed. If the facts stated in the application are found to be misrepresented, the loan may become immediately due and payable. In the event the Board of Directors, for good cause, deem any loan unsafe, additional security may be demanded and required.

Section 6. Loans to officers, directors, employees, loan officers, and to members of the Supervisory Committee shall not be in excess of the limitations provided by the Credit Union Act.

Article IX

Amendment of Bylaws

Amendments to these Bylaws, and amendments of the Articles of Incorporations, may be adopted by the affirmative vote of two-thirds of the total members of the Board thereof, after the members of the Board have been given at least ten days notice of said meeting and the notice has contained a copy of the proposed amendment or amendments. No amendment of these Bylaws or the Articles of Incorporation shall become effective, however, until approved, in writing, by the Commissioner of Banking.

A-157740
49482

Commonwealth of Kentucky

Department of State



Office of Secretary of State

CHARLES K. O'CONNELL, SECRETARY

DOMESTIC CORPORATION DEPARTMENT

NON-STOCK CORPORATION

I, Charles K. O'Connell, Secretary of the State of Kentucky, hereby certify that a certified copy of Articles of Incorporation of the STATE HEALTH EMPLOYED CREDIT UNION, INC., LOUISVILLE, KENTUCKY has this day been filed in my office.

It appearing from said Articles of Incorporation that the said Corporation has no capital stock, and no private pecuniary profit is to be derived therefrom, the said Corporation is not required by law to pay a tax on organization; and it further appearing that the aforesaid Corporation has complied with all the requirements of the law, this certificate is issued as evidence of the fact that the said Corporation is now authorized and empowered to do business in this State under its charter, subject to the restrictions imposed by the statutes of Kentucky.



SECRETARY OF STATE

Given under my hand as Secretary of State,
this NINTH day of JUNE 1925

Charles K. O'Connell
Secretary of State

By J. E. Greene
Chief Clerk, Corporation Department.

ARTICLES OF INCORPORATION
(and Articles of Agreement)

State Health Employees

CREDIT UNION, Inc.

We, the undersigned, residents of the State of Kentucky, do hereby apply for permission to organize a Credit Union and do enter into these Articles of Agreement and do hereby bind ourselves to comply with these Articles of Incorporation and with all laws, rules and regulations applicable to Credit Unions in Kentucky; and hereby certify as follows:

(1) The name of the proposed Credit Union is the State Health Employees

Credit Union, Inc;

(2) This incorporation is desired in accordance with the provisions of Chapter 16 of the Acts of 1922 of the General Assembly of the State of Kentucky, as amended by the General Assembly in 1940, entitled: "An Act to Provide for the Establishment and Operation of Credit Unions in the Commonwealth of Kentucky."

(3) The par value of the shares shall be five dollars (\$5.00) per share.

(4) The principal office of the Credit Union shall be in Louisville, Kentucky.

(5) The names and addresses of the subscribers to these Articles of Incorporation and the number of shares subscribed by each are as follows:

Name and Address	Shares Subscribed
Theodora S. Baumberger	3918 Nanz Ave. (1)
William Axton	L-9 Green Tree Manor (5)
Bartha Justice	Route 3, Box 110, Anchorage, Ky. (1)
Charles W. DeSpain	817 E. Madison (1)
Lucy B. Trigg	2115 Highland Ave. (1)
Roma D. Sweeney	3214 W. Broadway (1)
Margaret Cotton	322 Warnock (1)
Doris Pederson	1719 Yale Drive (2)
Lois E. Zoll	316 Scout St. (1)
Bruce Underwood	3313 Oriole Drive (1)
William A. Kensingar	232 Chenoweth Lane (1)
Jess L. Cusick, Jr.	131 Crescent Ave. (1)
Mary C. Krah	2207 Tyler Lane (1)
Rodney Quillen	5714 Morrison Ave. (2)
M. E. Niswonger	419 Breckenridge Lane (5)
C. F. Hancock	3608 Dayton Ave. (2)
Dora Greenberg	430 E. Chestnut St. (1)
Kathryn Diem	222 Kennedy (1)

IN WITNESS WHEREOF, we have made, signed and acknowledged these Articles of Incorporation and Articles of Agreement, in triplicate this _____ day of _____ 19__

1 Theodora S. Baumberger 2 Margaret Cotton 3 Mary C. Krah
 4 William Axton 5 Doris Pederson 6 Rodney Quillen
 7 Bartha Justice 8 Lois Zoll 9 M. E. Niswonger
 10 Charles W. DeSpain 11 Bruce Underwood 12 C. F. Hancock
 13 Lucy B. Trigg 14 William A. Kensingar 15 Dora Greenberg
 16 Roma D. Sweeney 17 Jess L. Cusick, Jr. 18 Kathryn Diem

PROCESS AGENT: Jess L. Cusick, Jr. 131 Crescent Avenue, Louisville, Kentucky
 STATE OF KENTUCKY
 COUNTY OF JEFFERSON

Before me, the undersigned, a Notary Public in and for said County and State of Kentucky, personally appeared the above named parties, and severally acknowledged the foregoing Articles of Incorporation and Articles of Agreement. Witness my hand and notarial seal this _____ day of _____ 19__

Robert E. Morrison
 Notary Public

My commission expires March 30th, 19__

EXAMINED AND APPROVED June 8-52
 DEPARTMENT OF BANKING, STATE OF KENTUCKY
H. H. Carter
 Commissioner

EXECUTIVE COMMITTEE

WM. M. DUANE

C. H. DIERGING

R. A. SMITH

L. J. LIBBERT

R. L. KAHNE



KENTUCKY CREDIT UNION LEAGUE

AFFILIATED WITH CREDIT UNION NATIONAL ASSOCIATION

306 HORTON BUILDING

CLAY 1848 - MAGNOLIA 3871

LOUISVILLE 2, KENTUCKY

June 6, 1952

W. L. VANDENBURGH
MANAGING DIRECTOR

OFFICERS

WM. M. DUANE, PRESIDENT
BROWN WILLIAMS TOBACCO CO.,
LOUISVILLE, KENTUCKY

C. H. DIERGING, VICE PRESIDENT
LOUISVILLE TRAMWAY COMPANY
LOUISVILLE, KENTUCKY

R. A. SMITH, SECRETARY
STANDARD OIL COMPANY OF KY.
LOUISVILLE, KENTUCKY

L. J. LIBBERT, TREASURER
CORPS OF ENGINEERS US ARMY
LOUISVILLE, KENTUCKY

DIRECTORS

R. L. KAHNE, DIRECTOR AT LARGE
ARMCO STEEL CORPORATION,
ASHLAND, KY.

THOS. L. CECIL
AMERICAN RADIATOR & STANDARD
BATTERY CORPORATION
LOUISVILLE, KENTUCKY

E. D. STURGILL
INTERNATIONAL HARVESTER COMPANY
BENNAH, KENTUCKY

STEVE BRODY
FORD BROS. COMPANY
LOUISVILLE, KENTUCKY

PAUL L. MOORE
ILLINOIS CENTRAL RAILROAD SYSTEM
PADUCAH, KENTUCKY

MARTIN HOLLAND
C. T. BEARING BRITISH COMPANY
LOUISVILLE, KENTUCKY

NEWMAN M. ELLIOTT
NORTHEASTERN GREENHOUND LINES
LEXINGTON, KENTUCKY

B. K. BRANTLEY
BARNHEIM DISTILLING COMPANY
LOUISVILLE, KENTUCKY
D. T. WOODARD
AMERICAN TEL. & TEL. CO. LOU. KY.
NATIONAL DIRECTORS

WM. M. DUANE

R. L. KAHNE

CHAPTER DIRECTORS

CLYDE E. DAVIS
ARLINGTON CREDIT UNION CHAPTER
ARLINGTON, KY. PRESIDENT
EMPLOYER CREDIT UNION
ARLINGTON, KENTUCKY

A. G. WEIDLER
BLUE GRASS CREDIT UNION CHAPTER
REPLA CREDIT UNION
BEREA, KENTUCKY

L. J. LIBBERT
LOUISVILLE CREDIT UNION CHAPTER
LOUISVILLE DISTRICT NO. 2 ENGINEERS
EMPLOYER CREDIT UNION
LOUISVILLE, KENTUCKY

Mr. Charles K. O'Connell
Secretary of State
Commonwealth of Kentucky
Frankfort, Kentucky

Dear Mr. O'Connell:

We are pleased to enclose two (2) Articles of Incorporation of the STATE HEALTH EMPLOYEES CREDIT UNION, Incorporated (Kentucky Department of Health) 620 South Third Street, Louisville 2, Kentucky.

It is to be noted these documents carry the approval of the Hon. H. H. Carter, Commissioner, Department of Banking, as of June 4, 1952, and Process Agent, Mr. Jess L. Cusick, Jr., 131 Crescent Avenue, Louisville 6, Kentucky.

Also, you will find our check #91, June 6, in the amount of \$4.00, issued in your favor to cover Charter fee.

Kindly process these papers in accordance with the proper procedure, issue the necessary Charter and return one of the Articles in order that we may record in the County Clerk's office in Jefferson County.

Thanking you very kindly and with all personal good wishes, I am

Sincerely yours,

W. L. Vandenburg
W. L. Vandenburg
Managing Director

WLV/ab

CC: Mr. Jess L. Cusick, Jr.

Encls.

NOT FOR PROFIT

NOT FOR CHARITY

BUT FOR SERVICE

**EXECUTIVE SUMMARY
COMMONWEALTH CREDIT UNION
PROPOSED REPLACEMENT PENSION PLAN**

Commonwealth Credit Union ("CCU") has become ineligible for membership in KERS by virtue of expanding its membership base to include faculty and staff of colleges, universities and trade schools. Its ineligibility for KERS requires CCU to establish a replacement plan (the "Replacement Plan") for certain of its employees. CCU's goal is to: (1) design the Replacement Plan to provide future retirement benefits for certain current CCU employees that are generally consistent with the retirement benefits that are currently accrued by those employees under KERS, while (2) meeting CCU's financial goals.

CCU management ("Management") consulted with both legal and actuarial professionals in its consideration of a Replacement Plan design. Management presented an initial design proposal to the Board at its February 2015 meeting. The proposed design has been refined by Management after consideration of the Board's comments and additional consultation with legal and actuarial professionals. This Executive Summary describes that refined Replacement Plan design that Management proposes to the Board for its consideration.

1. When Will the Replacement Plan Become Effective?

The effective date of the Replacement Plan will be established after CCU reaches an agreement with KERS regarding the last date on which CCU employees will accrue benefits under KERS (the "KERS Freeze Date"). The Replacement Plan will become effective on the date that immediately follows the KERS Freeze Date (the "Transition Date").

2. Will the Replacement Plan Be Identical to KERS?

Not completely. KERS is a governmental defined benefit pension plan and, therefore, is not subject to ERISA and the parallel provisions of the Internal Revenue Code. Because CCU is a nongovernmental employer, the Replacement Plan must fully comply with ERISA and the parallel provisions of the Internal Revenue Code, including their respective requirements relating to nondiscrimination, fiduciary standards, funding of benefits, reporting and disclosure, and enforcement.

CCU employees are currently required to make pretax employee contributions to KERS. An ERISA defined benefit plan cannot accept pretax employee contributions. As a result, requiring employee contributions under the Replacement Plan would reduce each participant's take-home pay because the employee contributions would be after tax. Therefore, employee contributions are not required under the proposed Replacement Plan design.

Certain CCU employees are currently permitted to purchase additional years of benefit service under KERS ("Purchased Service"). An ERISA defined benefit plan may not permit such purchases. Therefore: (a) Purchased Service may not be recognized by the Retirement Plan for the purpose of calculating any participant's Replacement Plan benefit; and (b) no employee may purchase years of service under the Replacement Plan.

3. Who Will Be Eligible to Participate in the Replacement Plan?

The group of employees who will be eligible to participate in the Replacement Plan is a closed group. Each individual who is: (i) a participant in KERS on the KERS Freeze Date; and (ii) employed by CCU on the Transition Date will participate in the Replacement Plan. No other CCU employees will be permitted to participate in the Replacement Plan.

4. What About Rehired Employees?

A Replacement Plan participant who terminates employment with CCU and is subsequently rehired by CCU will not be eligible to accrue additional benefits under the Replacement Plan during his or her period of reemployment.

5. When Do Participants Become Vested in Their Replacement Plan Benefits?

Each participant who is vested in his or her KERS retirement benefit will be immediately vested in his or her Replacement Plan benefit. Any participant who is not vested in his or her KERS retirement benefit will become vested in his or her Replacement Plan benefit upon the completion of his or her fifth year of vesting service. For this purpose, the Replacement Plan will recognize each participant's service from his or her date of hire, including service in years prior to the Transition Date.

6. When May Replacement Plan Participants Begin Receiving Normal Retirement Benefits from the Replacement Plan?

Each Replacement Plan participant who terminates employment with CCU may begin receiving payment of his or her normal retirement benefit from the Replacement Plan as of the first day of any month following his or her attainment of age 65.

7. How Will Normal Retirement Benefits Be Calculated Under the Replacement Plan?

Each Replacement Plan participant's normal retirement benefit will be calculated using the following formula:

$$\begin{array}{c} ((2.0\% \times \text{Final Compensation}) \times \text{years of Benefit Service}) \\ \text{minus} \\ \text{Frozen KERS Benefit} \end{array}$$

For purposes of the above formula, the Replacement Plan will recognize each participant's service from his or her date of hire by CCU, including service in years prior to the Transition Date.

Final compensation is determined for each participant by averaging his or her highest five years of compensation that he or she received from CCU. This determination is based on all years of compensation, including compensation earned in years prior to the effective date of the Replacement Plan.

A participant's "Frozen KERS Benefit" is equal to the greater of (a) and (b), where (a) is equal to the participant's certified accrued benefit that is payable from KERS at his or her actual retirement age; and (b) is equal to the participant's certified accrued benefit that is payable from KERS at the earliest age at which he or she may receive retirement benefits from

KERS. Any Purchased Service will not be recognized when calculating the amount of the participant's Frozen KERS Benefit. The amount of the Frozen KERS Benefit as of the Transition Date will be actuarially certified by KERS and will not automatically fluctuate after the Transition Date.

8. When May Replacement Plan Participants Begin Receiving Early Retirement Benefits from the Replacement Plan?

Each Replacement Plan participant who: (i) terminates employment with CCU prior to attaining age 65; and (ii) meets any of the following criteria that is set forth in Section 8.a. or 8.b. below may elect to receive an early retirement benefit from the Plan. Early retirement benefit payments may commence as of the first day of any month on or after the date on which the participant becomes eligible to receive an early retirement benefit. In order to be eligible to receive an early retirement benefit from the Replacement Plan, the participant must have either:

- a. attained age 55 and completed 5 years of service for vesting; or
- b. completed at least 25 years of service for vesting (regardless of age).

9. How Are Early Retirement Benefits Calculated Under the Replacement Plan?

The amount of monthly early retirement benefit that a participant will receive from the Replacement Plan depends on the manner in which he or she is categorized under the Replacement Plan for early retirement benefit purposes. Each participant is categorized into one of the three categories that are described in Sections 9.a. through 9.c. below.

a. Category I: Each Participant Who Has Reached Age 55 and Completed at Least 5 (but less than 25) Years of Service for Vesting.

Each Category I participant will be eligible for a reduced early retirement benefit. The early retirement benefit will equal the amount of the participant's accrued normal retirement benefit calculated under the formula that is described in Section 7. above, reduced in accordance with the following chart:

Years Until Lesser of Age 65 or 27 Years of Service	Percentage of Normal Retirement Benefits Paid
1	93.5%
2	87.0%
3	80.5%
4	74.0%
5	67.5%
6	63.0%
7	58.5%
8	54.0%
9	49.5%
10	45.0%

b. Category II: Each Participant Who Has Completed at Least 25 (but less than 27) Years of Service for Vesting.

Each Category II participant will be eligible for a reduced early retirement benefit. The early retirement benefit will equal the amount of the participant's accrued normal retirement benefit calculated under the formula that is described in Section 7. above, reduced in accordance with the chart in Section 9.a. above.

Each Category II participant who: (i) is classified under federal law as a non-highly compensated employee on his or her employment termination date; and (ii) whose early retirement benefit begins before his or her attainment of age 55 will also be eligible for a temporary early retirement supplement from the Replacement Plan. The amount of the early retirement supplement will be equal to his or her Frozen KERS Benefit payable at age 55. Payments of the early retirement supplement will stop as of the first day of the month on or after the participant's attainment of age 55.

c. Category III: Each Participant Who Has Completed at Least 27 Years of Service for Vesting.

Each Category III participant will be eligible for an unreduced benefit from the Replacement Plan that is calculated under the formula that is described in Section 7. above.

Each Category III participant who: (i) is classified under federal law as a non-highly compensated employee on his or her employment termination date; and (ii) whose early retirement benefit begins before his or her attainment of age 55 will be eligible for a temporary early retirement supplement from the Replacement Plan. The amount of the early retirement supplement will be equal to his or her Frozen KERS Benefit payable at age 55. Payments of the early retirement supplement will stop as of the first day of the month on or after the participant's attainment of age 55.

10. How Will Retirement Benefits Be Paid?

More restrictive rules apply under the Internal Revenue Code with respect to forms of payment that are permitted under a nongovernmental plan. In general, each married participant's retirement benefit must be paid from the Replacement Plan in the form of a joint life and 50% survivor annuity for the participant and his or her spouse. Each unmarried participant's retirement benefit will be paid from the Replacement Plan in the form of a single life annuity for the participant. These are often referred to as the "Automatic Forms of Payment." An Automatic Form of Payment may be waived by a participant (with proper spousal consent, if the participant is married) in favor of payment in another available form.

11. Will Death Benefits Be Paid From the Replacement Plan on Behalf of a Participant Who Dies Prior to Retirement?

The surviving spouse of a vested participant who dies prior to the date on which his or her retirement benefit payments begin will be eligible to receive a death benefit from the Replacement Plan. The amount of the death benefit will be equal to the amount that would have been payable to the spouse had the participant: (a) survived to normal retirement age and elected a joint life annuity with 50% payable to his or her spouse; and (b) died after the participant's retirement benefit payments commenced. Each participant will be permitted to name a non-

spouse beneficiary. However, each married participant must obtain proper spousal consent to the naming of a non-spouse beneficiary.

12. How Will the Replacement Plan Be Funded?

The Replacement Plan will be funded entirely by CCU.

This Executive Summary discusses only the most significant proposed Replacement Plan design features. Management recommends approval of the proposed Replacement Plan design that is described in this Summary. Plan documents that implement the design will be presented for approval at a subsequent Board meeting.

**EXECUTIVE SUMMARY
COMMONWEALTH CREDIT UNION
PROPOSED ENHANCED 401(k) PLAN**

Commonwealth Credit Union ("CCU") maintains an ERISA 401(k) Plan (the "401(k) Plan") for its employees. The current 401(k) Plan permits employee pretax voluntary contributions. It does not provide for employer contributions.

CCU is in the process of withdrawing from KERS. Management has considered CCU's goals relating to retirement benefits for current and future employees in light of that withdrawal. Management believes that CCU's commitment to certain current employees should be reflected in a replacement pension plan that is similar to the KERS plan for which CCU's current employees will no longer be eligible. Management's recommendations in that regard appear elsewhere. Management also believes that CCU's retirement plan commitment to employees who do not participate in the replacement pension plan should (1) be sufficiently attractive to enable CCU to attract high-quality employees, and (2) not create a financial burden for CCU that negatively affects its ability to serve its members.

Management has evaluated various changes to the 401(k) Plan that would achieve the foregoing goals. It has been assisted in that process by outside actuarial and legal advisors. Based on that review, Management believes that CCU's retirement benefit goals for those employees who do not participate in the replacement pension plan will best be achieved by the implementation of a 401(k) Plan design that involves annual employer contributions in a specific percentage of each eligible employee's compensation. Employees who participate in the replacement pension plan would not be eligible to receive this employer 401(k) Plan contribution (because their employer-paid retirement benefit would be provided through the replacement pension plan). Employees who participate in the replacement pension plan will, however, remain eligible to make pretax voluntary payroll deduction contributions to the 401(k) Plan.

The proposed employer contribution formula options that Management initially considered were presented to the Board at its February 2015 meeting. After consideration of the Board's comments and additional consultation with legal and actuarial professionals, Management has decided on a recommended formula. This Executive Summary describes the employer contribution formula that Management proposes for Board consideration.

1. Will the Current Employee Pretax Voluntary Contribution Structure of the 401(k) Plan be Changed?

No. The current design of the employee pretax voluntary contribution portion of the 401(k) Plan will remain intact. The new employer contribution feature (the "Employer Contribution Feature") will be in addition to the 401(k) feature that already exists.

2. When Will the Employer Contribution Feature Become Effective?

The effective date of the Employer Contribution Feature will be established after CCU reaches an agreement with KERS regarding the last date on which CCU employees will accrue benefits under KERS (the "KERS Freeze Date"). The Employer Contribution Feature

will become effective on the date that immediately follows the KERS Freeze Date (the "Transition Date").

3. Who Will Be Eligible to Participate in the Employer Contribution Feature?

Each CCU employee who: (a) is not eligible to participate in the CCU replacement pension plan on the Transition Date; and (b) has completed a minimum of 1,000 hours of service in a relevant 12-month ERISA measuring period will be eligible to participate in the Employer Contribution Feature. Each employee will become a participant in the Employer Contribution Feature at some date on or after his or her satisfaction of these criteria ("Entry Date"). CCU must discuss with CUNA the frequency under which employees may begin participation in the Employer Contribution Feature in order to establish Entry Dates. Entry Dates that are commonly established under ERISA plans are daily, monthly, quarterly and semi-annual.

Because an ERISA plan cannot exclude employees solely on the basis of part-time status, the eligibility criteria that is described in the paragraph above applies to both full-time and part-time CCU employees. For example:

Employee A is classified under CCU personnel policies as a part-time employee, and works approximately 90 hours per month. Employee A completes 1,080 hours in a 12-month ERISA measuring period. Therefore, Employee A is eligible to participate in the Employer Contribution Feature upon completion of 1,000 hours of service. She: (a) becomes a participant in the Employer Contribution Feature as of her next Entry Date despite her part-time status; and (b) is eligible to receive the employer matching and profit sharing contributions that are discussed in Section 4. for the Plan Year that includes her Entry Date and for each subsequent Plan Year during her employment with CCU.

4. How Will Employer Contributions Be Calculated Under the Employer Contribution Feature?

CCU will make two types of contributions to the 401(k) Plan under the Employer Contribution Feature. Each type of contribution is discussed below.

a. Employer Profit Sharing Contribution. For each Plan Year, CCU will also make a profit sharing contribution to the 401(k) Plan on behalf of each full-time or part-time employee who is a participant in the Employer Contribution Feature. Each participant in the Employer Contribution Feature will receive a profit sharing contribution from CCU that is equal to 3% of his or her pay for the relevant Plan Year, regardless of whether he or she makes elective deferral contributions to the Plan. This contribution will be made for each participant in the Employer Contribution Feature regardless of whether he or she makes pretax voluntary contributions to the 401(k) plan and regardless of the number of hours of service he or she completes during the Plan Year to which the profit sharing contribution relates.

b. Employer Matching Contribution. For each Plan Year, CCU will make a matching contribution to the 401(k) Plan on behalf of each full-time or part-time employee who: (i) is a participant in the Employer Contribution Feature; and (ii) makes voluntary pretax contributions to the 401(k) Plan. Each employee who meets that criteria will receive a 50% matching contribution from CCU with respect to the first 6% of his or her pay that he or she contributes to the 401(k) Plan for the relevant Plan Year (a maximum of 3% of pay contributed by the Credit Union). (This contribution is referred to as a "401(m) Contribution" in the Retirement Benefits Program Projected Annual Cost Estimates as of January 1, 2015 that is dated April 21, 2015 and was prepared by Watkins Ross.)

5. How Will the Employer Contribution Feature Be Funded?

The Employer Contribution Feature will be funded entirely by CCU.

This Executive Summary discusses only the basic structure of the Employer Contribution Feature. Management recommends approval of the proposed employer contribution formula that is described in this Executive Summary. Plan documents that implement the entire design of the Employer Contribution Feature (including vesting, investment and distribution provisions) will be presented for approval at a subsequent Board meeting.

**EXECUTIVE SUMMARY
COMMONWEALTH CREDIT UNION
REPLACEMENT RETIREE MEDICAL BENEFIT**

Commonwealth Credit Union ("CCU") has traditionally provided retiree medical benefits to eligible individuals through its membership in KERS. CCU has become ineligible for membership in KERS by virtue of expanding its membership base to include faculty and staff of colleges, universities and trade schools. Accordingly, CCU employees will, upon CCU's withdrawal from KERS, be ineligible to accrue additional retiree medical benefits under the KERS retiree medical program.

In order to provide certain employees with a retiree medical benefit, CCU will implement a replacement retiree medical program (the "CCU Retiree Medical Benefit Plan"). CCU management presented an initial CCU Retiree Medical Benefit Plan design proposal to the Board at the Board's February 2015 meeting. The proposed design of the Plan has been refined by CCU management after consideration of the Board's comments and additional consultation with legal and actuarial professionals. This Executive Summary describes that refined CCU Retiree Medical Benefit Plan that CCU management now proposes to the Board for its consideration.

I. Effective Date. The effective date of the CCU Retiree Medical Benefit Plan will be established after CCU reaches an agreement with KERS regarding the last date on which CCU employees will accrue benefits under KERS (the "KERS Freeze Date"). The CCU Retiree Medical Benefit Plan will become effective on the date that immediately follows the KERS Freeze Date (the "Transition Date").

II. Eligibility. Each individual who (i) is a participant in KERS on the KERS Freeze Date, (ii) has earned fewer than 20 years of service under the KERS retiree medical program (the "KERS Program") as of the Transition Date, and (iii) is employed by CCU on the Transition Date is eligible to earn a retiree medical benefit under the CCU Retiree Medical Benefit Plan (an "Eligible Employee"). The eligibility requirements that apply when determining which individuals will actually receive benefits under the CCU Retiree Medical Benefit Plan are described in Section III. below.

III. CCU Retiree Medical Benefit Plan Summary. The CCU Retiree Medical Benefit Plan will provide a retiree medical benefit only to Eligible Employees (i) who terminate employment after having earned at least 10 years of service with CCU and (ii) who, upon employment termination, are eligible to immediately begin receiving benefit payments from the CCU pension plan (an "Eligible Retiree"). The structure of the CCU Retiree Medical Benefit Plan is described in the chart that appears below.

Number of Years of Service under the KERS Program as of the Transition Date	CCU Payment Toward Post-Retirement Medical Expenses
New hires on and after the Transition Date	-0-
Less than 20 years ("Current Employees")	\$10 per month for each year of service that is earned after the Eligible Employee's date of hire if the Eligible Employee becomes an Eligible Retiree
20 or more years ("Long Term Employees")	-0-

Based on the chart that appears above, the CCU Retiree Medical Benefit Plan will be administered as described below.

A. New Hires and Rehires. Any individual who is not an Eligible Employee is ineligible to earn a retiree medical benefit from CCU. Accordingly, any individual who is first hired on or after the Transition Date or who terminated employment with CCU before the KERS Freeze Date and is rehired on or after the Transition Date is ineligible to earn a CCU Retiree Medical Benefit Plan benefit. Any individual who is ineligible to participate in the CCU pension plan is also ineligible to earn a benefit under the CCU Retiree Medical Benefit Plan.

B. Current Employees. An Eligible Employee who (i) has less than 20 years of service under the KERS Program as of the Transition Date and (ii) becomes an Eligible Retiree is eligible to receive a retiree medical benefit from the CCU Retiree Medical Benefit Plan. That benefit is equal to \$10 per month for each year of service with CCU that the Employee earned after his or her original date of hire. The benefit amount for any Eligible Retiree who retires from CCU and is subsequently rehired will be determined based upon the years of service that the Retiree had earned as of his or her initial retirement date. That Retiree will receive no credit for any Plan purposes for years of service that are earned after his or her rehire date.

C. Long Term Employees. Any individual who has 20 or more years of service under the KERS Program as of the Transition Date is ineligible to earn a CCU Retiree Medical Benefit Plan benefit.

Notwithstanding the foregoing, the monthly benefit that an Eligible Retiree will receive under the CCU Retiree Medical Benefit Plan shall not exceed the lesser of: (i) the monthly benefit amount determined pursuant to the chart that appears above; and (ii) the dollar amount of post-retirement monthly health insurance premiums for which the Retiree is responsible for payment (including premiums incurred through participation in the KERS retiree medical insurance plan and premiums incurred through the purchase of individual health insurance such as a Medicare supplement insurance policy).

IV. Use of Benefit. An Eligible Retiree may use the Plan benefit for the reimbursement of any post-retirement medical insurance premiums that are paid by the Retiree, even if the Retiree begins working for a subsequent employer after terminating employment with CCU. The Plan benefit may not be used to reimburse premiums associated with coverage under another employer's group health plan.

V. Benefit Termination. An Eligible Retiree will cease to be a Plan participant and cease receiving his or her CCU Retiree Medical Benefit Plan benefit during any period of reemployment with CCU. An Eligible Retiree will also cease receiving his or her CCU Retiree Medical Benefit Plan benefit as of his or her date of death. No benefits to an Eligible Retiree's spouse and dependents will be provided under the CCU Retiree Medical Benefit Plan after the Retiree's death. However, an Eligible Retiree's spouse or dependents may submit for payment from the CCU Retiree Medical Benefit Plan eligible health insurance premium expenses that the Retiree incurred before his or her date of death.

VI. Vesting. An Eligible Employee will be 100% vested in his or her CCU Retiree Medical Benefit Plan benefit upon becoming an Eligible Retiree. An Eligible Employee will receive credit for vesting purposes for each year of service that the Employee has earned since his or her date of hire with CCU.

VII. Year of Service. An Eligible Employee will earn a year of service under the CCU Retiree Medical Benefit Plan for each year that he or she works at least 1,000 hours of service for CCU. For all Plan purposes, an Eligible Employee will begin to earn years of service credit beginning on his or her date of hire with CCU.

VIII. Funding. The CCU Retiree Medical Benefit Plan will not be formally funded through a welfare benefit plan trust. Rather, CCU will pay Plan claims from its general assets as those claims are due.

This Summary discusses only the most significant proposed CCU Retiree Medical Benefit Plan design features. Management recommends the approval of the proposed CCU Retiree Medical Benefit Plan design. Plan documents that implement the design will be presented for approval at a subsequent Board meeting.

**Kentucky Retirement Systems**

Perimeter Park West • 1260 Louisville Rd. • Frankfort KY 40601-6124
Phone: (502) 696-8800 • Fax: (502) 696-8822 • kyret.ky.gov



Form 7725
Revised 10/2015

Request For Estimated Actuarial Cost of Voluntary Cessation**Agency Information**

Full Legal Name of Agency: Commonwealth Credit Union, Inc.		Phone Number: 502-564-4775	
Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
KRS Employer Code 7410			

Name of person to contact regarding this application for estimate: Karen Harbin			
Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
Phone Number: 502-564-5564	Fax: 502-564-8146	E-mail: kharbin@cwcu.org	

Name of Agency Head: Karen Harbin			
Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
Phone Number: 502-564-5564	Fax: 502-564-8146	E-mail: kharbin@cwcu.org	

Name of Reporting Official: Leslie Proctor			
Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
Phone Number: 502-564-4775	Fax: 502-564-8146	E-mail: lproctor@cwcu.org	

Name of Attorney representing agency (if any): Stephen I. Jurmu			
Address: 313 South Washington Square	City: Lansing	State: MI	Zip Code: 48933
Phone Number: 517-371-8260	Fax: 517-367-7360	E-mail: sjurmu@fosterswift.com	

This estimate of the full actuarial cost of voluntary cessation provided by Kentucky Retirement Systems will be based on unaudited information currently in Kentucky Retirement Systems' database with projections that current employees will stay employed and earn service credit until the next available cessation date and will continue to earn the same creditable compensation. Pursuant to 105 KAR 1:145, this estimate shall not be binding on Kentucky Retirement Systems and shall not be relied upon by the requesting employer.

I, Karen Harbin President/CEO
Name of Agency Head Title of Agency Head acknowledge and agree

that the estimate of the full actuarial cost of voluntary cessation to be provided by Kentucky Retirement Systems is only an estimate based on unaudited information currently in Kentucky Retirement Systems' database with projections that current employees will stay employed and earn service credit until the next available cessation date and will continue to earn the same creditable compensation. Pursuant to 105 KAR 1:145, this estimate shall not be binding on Kentucky Retirement Systems and shall not be relied upon by the requesting employer.

Karen C. Harbin
Agency Head Signature

**Kentucky Retirement Systems**

Perimeter Park West • 1260 Louisville Rd. • Frankfort KY 40601-6124
Phone: (502) 696-8800 • Fax: (502) 696-8822 • kyret.ky.gov



Form 7730
Revised 11/2015

Application for Voluntary Cessation From CERS or KERS**Agency Information**

Full Legal Name of Agency: Commonwealth Credit Union, Inc.		Phone Number: 502-564-4775	
Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601

KRS Employer Code	7410
-------------------	------

Name of person to contact regarding this application:	Karen Harbin
---	--------------

Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
Phone Number: 502-564-5564	Fax: 502-564-8146	E-mail: kharbin@cwcu.org	

Name of Agency Head:	Karen Harbin
----------------------	--------------

Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
Phone Number: 502-564-5564	Fax: 502-564-8146	E-mail: kharbin@cwcu.org	

Name of Reporting Official:	Leslie Proctor
-----------------------------	----------------

Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
Phone Number: 502-564-4775	Fax: 502-564-8146	E-mail: lproctor@cwcu.org	

Name of Attorney representing agency:	Stephen I. Jurmu
---------------------------------------	------------------

Address: 313 South Washington Square	City: Lansing	State: MI	Zip Code: 48933
Phone Number: 517-371-8260	Fax: 517-367-7360	E-mail: sjurmu@fosterswift.com	

Board Chair:	Alex W. Rose
--------------	--------------

Attach List of Current Board Members

Date of Resolution: (Attach Resolution)	December 17, 2015
---	-------------------

Attach Notarized copy of the official minutes of the meeting the resolution was adopted, if applicable

Name of proposed Alternative Retirement Program:	CUNA Mutual Group
--	-------------------

Type of Plan:	Defined Benefit Plan & Enhanced Defined Contribution Plan (401K) & Retiree Medical Subsidy
---------------	--

Attach documentation of alternative retirement plan

If the agency is a corporation organized under KRS Chapter 273:

Secretary of State Organization Number:	0157740
---	---------

Name of Registered Agent:	Karen Harbin
---------------------------	--------------

Address: 417 High Street	City: Frankfort	State: KY	Zip Code: 40601
--------------------------	-----------------	-----------	-----------------

Attach copies of Articles of Incorporation, By-Laws, Certificate of Existence/Authorization, if applicable

Attach the following information for all current and former full time employees:

- Full names;
 - Last known addresses;
 - Dates of Birth;
 - Social Security Numbers of Kentucky Retirement Systems Member IDs;
 - Beginning dates of employment, if applicable;
 - Ending dates of employment, if applicable; and
 - Sick leave balances;
 - Provide a list of active lawsuits, legal actions, arbitrations, mediations and other litigation, except for cases in which the employer is seeking to collect a debt owed to it by one of its members, pending to which the employer is a party including:
 - Name of the case;
 - Number of the case;
 - The name and address of the Court, arbitrator, mediator, or administrative agency in which the case is pending.
- Attach a copy of the Complaint or a description of the allegations made in the Complaint as well as the type and amount of relief being sought.

Attach:

- The employer's most recent five (5) audited financial statements and independent auditor's reports;
- The employer's most recent five (5) Consolidated Annual Financial Reports, if applicable;

☒ If employer intends to pay by lump sum:

- Documentation of the employer's plan to pay the full actuarial cost including:
- Funding source;

☐ If employer intends to pay by installment payment plan:

- Documentation of the employer's plan to pay the full actuarial cost including:
- Funding source;
- List of real property owned by the employer, including deeds of conveyance, title, all liens or encumbrances on the real property and any current written contractual lease or rental agreement of the real property identified;
- List of liabilities of the employer, and inventory of all other chattel and personal property owned by the employer or in which the employer has an interest that may be used as collateral by the employer, including a description of the property, the location of the property, and an estimated value;
- Proposed Detailed Financing Statement, if the employer intends to pay in installments;

Name of Attorney preparing Detailed Financing Statement: _____

Address: _____

City: _____

State: _____

Zip Code: _____

Phone Number: _____

Fax: _____

E-mail: _____

I, Karen Harbin
NAME OF AGENCY HEAD

President/CEO
TITLE OF AGENCY HEAD

acknowledge

and agree that Commonwealth Credit Union, Inc. is subject to and will comply with all the provisions KRS 61.552 and
NAME OF AGENCY

KAR 1:145.

Karen C. Harbin
Signature line for Agency Head

I, Alex W. Rose
NAME OF BOARD CHAIR

Chair of the Board of Trustees, acknowledge and agree that

Commonwealth Credit Union, Inc. is subject to and will comply with all the provisions KRS 61.552 and 105 KAR 1:145.
NAME OF AGENCY

Alex W. Rose
Signature line for Board Chair

PAYEE: KENTUCKY RETIREMENT SYSTEM

Check No: 0000103569
Amount: \$ 5,000.00
Post Date: 12/15/15
Issue Date: 12/15/15

INVOICE #	DESCRIPTION	DATE	AMOUNT
12142015	11025-KRS FORM 7725	12/14/15	5,000.00


COMMONWEALTH
CREDIT UNION
417 HIGH STREET • P.O. BOX 978
FRANKFORT, KENTUCKY 40602-0978
502.544.4775 • 800.228.6420

OFFICIAL CHECK

73-7844/2839

DATE
12/15/15

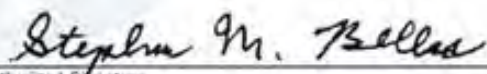
04-0000103569

\$5,000.00

PAY ** Five Thousand and 00/100 DOLLARS **

DRAWER: COMMONWEALTH CREDIT UNION

TO THE
ORDER
OF
KENTUCKY RETIREMENT SYSTEM
PERIMETER PARK WEST
1260 LOUISVILLE RD
FRANKFORT KY 40601


Authorized Signature

⑈0000103569⑈ ⑆283978441⑆ ⑆11006106710287⑈

PAYEE: KENTUCKY RETIREMENT SYSTEM

Check No: 0000103570
Amount: \$ 10,000.00
Post Date: 12/15/15
Issue Date: 12/15/15

INVOICE #	DESCRIPTION	DATE	AMOUNT
121420152	11025-KRS FORM 7730	12/14/15	10,000.00


COMMONWEALTH
CREDIT UNION
417 HIGH STREET • P.O. BOX 978
FRANKFORT, KENTUCKY 40602-0978
502.564.4775 • 800.228.6820

OFFICIAL CHECK

73-7844/2839

DATE
12/15/15

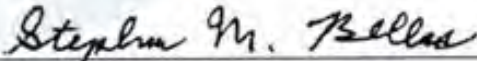
04-0000103570

\$10,000.00

PAY ** Ten Thousand and 00/100 DOLLARS **

DRAWER: COMMONWEALTH CREDIT UNION

TO THE
ORDER
OF
**KENTUCKY RETIREMENT SYSTEM
PERIMETER PARK WEST
1260 LOUISVILLE RD
FRANKFORT KY 40601**


Authorized Signature

⑈0000103570⑈ ⑆28397844⑆ ⑆1006106710287⑈



PO Box 978 • Frankfort, KY 40602-0978
800.228.6420 • 502.564.4775 • www.ccu.ky.org

December 23, 2015

Mr. William Thielen
Kentucky Retirement Systems
1260 Louisville Road
Frankfort, KY 40601

RE: Form 7730—List of pending lawsuits, legal action, arbitrations, mediations and other litigation to which CCU is a party.

Dear Bill,

Commonwealth Credit Union is not a party in any legal actions, lawsuits, arbitration, etc. with the exception of cases in which the credit union is seeking to collect a debt owed (i.e. bankruptcies and foreclosures).

Sincerely,

Karen C. Harbin, CPA, CGMA
President/CEO
Commonwealth Credit Union

CC: Brian Thomas, Esq.
Kentucky Retirement Systems

Source of Funds of Commonwealth Credit Union for Unfunded Pension Liability

Included is Page 4 from the September 30, 2015 Call Report that the credit union is required to file each quarter with the National Credit Union Administration (NCUA). Line 31. Undivided Earnings shows a balance of \$171,406,584. This amount is the equity we have built since our inception. Per our auditor, we have confirmed that Commonwealth Credit Union can apply this balance to fund our portion of the unfunded pension liability to be paid to the Kentucky Retirement System (KRS). Our historical call reports can be found by at www.NCUA.gov.

We normally keep \$50 million and up in liquid cash balances that we could use, but I have also included the most recent data from the Federal Home Loan Bank of Cincinnati that highlights our Maximum Borrowing Capacity (MBC). As of 12/16/2015, the MBC for Commonwealth Credit Union is \$186,745,837. This highlights our ability to pay the necessary balances without any restrictions as requested.



Credit Union Name: COMMONWEALTHFederal Charter/Certificate Number: 61437**STATEMENT OF FINANCIAL CONDITION AS OF: SEPTEMBER 30 2015***This page must be completed by all credit unions.*

EQUITY:	Amount	Acct code
31. Undivided Earnings.....	\$171,406,584	940
32. Regular Reserves.....	\$20,827,421	931
33. Appropriation for Non-Conforming Investments (State Credit Unions ONLY).....	\$0	668
34. Other Reserves (Appropriations of Undivided Earnings).....	\$0	658
35. Equity Acquired in Merger.....	\$0	658A
36. Miscellaneous Equity.....	\$0	998
37. Accumulated Unrealized Gains (Losses) on Available for Sale Securities.....	-\$677,073	945
38. Accumulated Unrealized Losses for OTTI (Due to Other Factors) on HTM Debt Securities.....	\$0	945C
39. Accumulated Unrealized Net Gains (Losses) on Cash Flow Hedges.....	\$0	945A
40. Other Comprehensive Income (unless already included in Item 38-39).....	\$0	945B
41. Net Income (unless this amount is already included in Undivided Earnings).....	\$6,980,813	602
42. TOTAL LIABILITIES, SHARES, AND EQUITY (Sum items 6-9, 18, and 31-41; must equal line 33, P 2.).....	\$1,019,778,906	014

If the credit union has any unfunded commitments or loans sold or swapped with recourse, complete Pg 10 - Liquidity, Commitments and Sources.

NCUA INSURED SAVINGS COMPUTATION

(ROUND CENTS TO THE NEAREST WHOLE DOLLAR. DO NOT REPORT CENTS.)

This section must be completed by all credit unions.

Insured shares and deposits, as described in Part 745 of the NCUA Rules and Regulations, are authorized by state law and issued to members (or nonmembers in the case of low-income designated credit unions), other credit unions, or government depositors. Report uninsured shares in this section. Do not include notes payable or other forms of borrowings. Eligible accounts are generally insured up to \$250,000 each. (See instructions for the following line items.)		
	Uninsured Amount	Acct Code
A. Uninsured IRA and KEOGH Member Shares and Deposits	\$357,529	065A1
A1. Uninsured KEOGH Member Shares and Deposits for Employee Benefit Plans	\$0	065A3
B. Uninsured Employee Benefit Member Shares and Deposits	\$0	065B1
C. Uninsured Member 529 Plan Deposits	\$0	065C1
D. Uninsured Member Accts Held by Government Depositors	\$356,971	065D1
E. Other Uninsured Member Shares and Deposits	\$17,352,832	065E1
F. TOTAL UNINSURED MEMBER SHARES AND DEPOSITS (A+A1+B+C+D+E)	\$18,067,332	065A4
G. Uninsured Nonmember Employee Benefit Shares and Deposits	\$0	067A1
H. Uninsured Nonmember Accts Held by Government Depositors	\$0	067B1
I. Other Uninsured Nonmember Shares and Deposits	\$0	067C1
J. TOTAL UNINSURED NONMEMBER SHARES AND DEPOSITS (G+H+I)	\$0	067A2
K. TOTAL UNINSURED SHARES AND DEPOSITS (F+J)	\$18,067,332	068A
L. TOTAL INSURED SHARES AND DEPOSITS (Item 18 from page 3 less Item K)	\$794,591,626	069A

Run date 12/16/2015 7:00:53 PM

FEDERAL HOME LOAN BANK OF CINCINNATI

Credit Risk Management

Additional Borrowing Capacity

As of 12/16/2015

COMMONWEALTH CREDIT UNION (DDA#: 050147)

FRANKFORT, KY.

ADVANCES SUMMARY:

FHLBank Advances:	\$0	Standby Letters of Credit (SLCs):	\$0
Guaranteed Funds Rate(GFRs):	\$0	Non-FHLBank Borrowings:	\$0
AHP/CIP Advances:	\$0	Advances and SLC original maturity > 5 Years:	\$0

STOCK CAPACITY

Capital Stock Balance:	\$1,711,300
Less: Membership Stock Requirement:	(\$1,175,045)
Stock Available for Activity:	\$536,255
Stock Based Additional Borrowing Capacity: (1)	\$26,812,760

COLLATERAL CAPACITY:

Maximum Borrowing Capacity:	\$186,745,837
Less: FHLBank Advances, GFRs, & SLCs:	\$0
Collateral Based Additional Borrowing Capacity:	\$186,745,837

MORTGAGE ASSETS CAPACITY

Residential Mortgage Assets as of: 09/30/2015	\$405,986,000
Less: FHLBank Advances GFRs, & SLCs that have original maturities greater than 5 years:	\$0
Mortgage Asset Based Additional Borrowing Capacity:	\$405,986,000

TOTAL BORROWINGS TO ASSETS CAPACITY

Total Assets as of: 09/30/2015	\$1,019,779,000
Multiplier:	50 %
	\$509,889,500
Less: Total Borrowings minus AHP/CIP Advances:	\$0
Total Borrowing Based Additional Borrowing Capacity:	\$509,889,500
Advance Maturity Restriction:	None

ADDITIONAL BORROWING CAPACITY: (2) \$26,812,760

(1) Additional Borrowing Capacity May be Limited By MPP Usage

(2) Additional Borrowing May be Limited by GFR Commitments

Run date 12/16/2015 6:00 PM

FEDERAL HOME LOAN BANK OF CINCINNATI

Credit Risk Management

BORROWING CAPACITY FROM PLEDGED COLLATERAL

As of 12/16/2015

Member Name: COMMONWEALTH CREDIT UNION

Member Headquarters: FRANKFORT KY

DDA: 50147

Data As Of Date: Wednesday, 2015 December 16

Pledged Asset Type

Bonds	Unpaid Principal Balance	Collateral Lendable Value	Borrowing Capacity	Restriction in Place
<i>Residential Mortgage Backed Securities</i>				
Agency	\$0	\$0	\$0	
Triple-A Rated	\$0	\$0	\$0	
Double-A Rated	\$0	\$0	\$0	
Other	\$0	\$0	\$0	
<i>Commercial Mortgage Backed Securities</i>				
Agency	\$0	\$0	\$0	
Triple-A Rated	\$0	\$0	\$0	
Double-A Rated	\$0	\$0	\$0	
Other	\$0	\$0	\$0	
US Agency Obligations	\$0	\$0	\$0	
US Treasury Obligations	\$0	\$0	\$0	
SBA Certificates	\$0	\$0	\$0	
<i>Municipal Obligations</i>				
Triple-A Rated	\$0	\$0	\$0	
Double-A Rated	\$0	\$0	\$0	
Single-A Rated	\$0	\$0	\$0	
Other	\$0	\$0	\$0	
Cash Deposits	\$0	\$0	\$0	
Total Cash and Securities	\$0	\$0	\$0	

Loans				
First Lien 1-4 Family Mortgage	\$224,411,559	\$214,757,713	\$188,745,837	No
Home Equity Lines of Credit	\$0	\$0	\$0	No
Residential Second Mortgage Installment	\$0	\$0	\$0	No
Multi-Family	\$0	\$0	\$0	No
Commercial Real Estate	\$0	\$0	\$0	No
Farm Real Estate	\$0	\$0	\$0	No
Commercial and Industrial				
Farm Business				
Total Loan Collateral	\$224,411,559	\$214,757,713	\$188,745,837	

Total Collateral Pledged	\$224,411,559	\$214,757,713	\$188,745,837
---------------------------------	----------------------	----------------------	----------------------

Outstanding Advances	\$0
Issued Letters of Credit	\$0
Total Borrowings	\$0
Additional Borrowing Capacity	\$188,745,837
Advance Maturity Restriction in Days	90

Definitions and Report Interpretation

Unpaid Principal Balance: Bond Securities	For mortgage backed or other asset backed security, this is the original face amount times the paydown factor. For other types of security, this is the face amount.
Unpaid Principal Balance: Loans	This is the balance of pledged loans reported to the FHLB as eligible (top line on distribution or total UPB for an issue on a listing).
Collateral Lendable Value: Bond Securities	This is the market value of the bond. This market value is, in most cases, the average of values provided by two separate pricing vendors.
Borrowing Capacity	The Lendable Value of the pledged assets net of the collateral haircut.
Restrictions in Place	A "Yes" in this field indicates that borrowing capacity against the pledged asset is limited to a certain percentage of total borrowing capacity or if it is restricted due to the member and loan type reflects profile.
Advance Maturity Restriction	This is the restriction expressed in calendar days of the maturity new advances or letters of credit, if any.
Other: Bond Securities	These fields reflect the balances, values and capacity against any securities that no longer meet FHLB's eligibility criteria. Generally, these bonds must be replaced based on a timeline established by the FHLB.

December 22, 2015

Mr. Bill Thielen
Kentucky Retirement Systems
Perimeter Park West
1260 Louisville Road
Frankfort, KY 40601-6124

Re: Form 7730 - Application for Voluntary Cessation from KERS
Form 7725 - Request for Estimated Actuarial Cost of Voluntary Cessation

Dear Mr. Thielen:

Enclosed is a Form 7730 - Application for Voluntary Cessation from KERS, including a check, issued by Kentucky Employers' Mutual Insurance (KEMI), in the amount of \$10,000 as a deposit toward the administrative costs associated with processing the Form 7730. Also enclosed is a Form 7725 - Request for Estimated Actuarial Cost of Voluntary Cessation, including a check, issued by KEMI, in the amount of \$5,000 for the administrative cost of obtaining the estimate. The following documents are also attached:

- List of Current Board Members
- Board Resolution to Cease Participation
- Documentation of Alternative Retirement Plan
- By-Laws
- KEMI's Enabling Legislation (KEMI does not have a Certificate of Existence/Authorization)
- List of Active Lawsuits and other Legal Actions Pending
- Documentation of Intention to Pay a Lump Sum

The following documents are being provided electronically through the secure portal provided by KERS:

- Spreadsheet with Required Information Regarding Current and Former Full Time Employees
- Most Recent Five (5) Audited Financial Statements
- Most Recent Five (5) Independent Auditor's Reports

As indicated on the Form 7730, KEMI's Board of Directors approved the Resolution to Cease Participation in the Kentucky Employees Retirement System at its December 1, 2015 meeting. Those minutes will not be approved until the Board meets again on February 9, 2016. However, our Board Chair completed a notarized certification that the Resolution was adopted by the Board which is attached to the Form 7730. Once the December minutes are approved, a notarized copy will be forwarded to you.

Please let me know if additional information is needed in order for the Board of KERS to approve the application and process the request for the actuarial estimate.

Sincerely,



Jon E. Stewart
President & CEO

cc: Brian Thomas

**Kentucky Retirement Systems**

Perimeter Park West • 1260 Louisville Rd. • Frankfort KY 40601-6124
Phone: (502) 696-8800 • Fax: (502) 696-8822 • kyret.ky.gov

[Print Form](#)

Form 7730
Revised 11/2015

Application for Voluntary Cessation From CERS or KERS**Agency Information**

Full Legal Name of Agency: Kentucky Employers' Mutual Insurance		Phone Number: 859-425-7800	
Address: 250 West Main, Suite 900	City: Lexington	State: KY	Zip Code: 40507

KRS Employer Code: 9940

Name of person to contact regarding this application: Jon Stewart

Address: 250 West Main, Suite 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859-425-7800	Fax: 859-425-7850	E-mail: jstewart@kemi.com	

Name of Agency Head: Jon Stewart

Address: 250 West Main, Suite 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859-425-7800	Fax: 859-425-7850	E-mail: jstewart@kemi.com	

Name of Reporting Official: Kellie Stadler

Address: 250 West Main, Suite 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859-425-7800	Fax: 859-425-7850	E-mail: kstadler@kemi.com	

Name of Attorney representing agency: Michelle Landers

Address: 250 West Main, Suite 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859-425-7800	Fax: 859-425-7850	E-mail: mlanders@kemi.com	

Board Chair: Rita Phillips

Attach List of Current Board Members

Date of Resolution: (Attach Resolution) December 1, 2015

Attach Notarized copy of the official minutes of the meeting the resolution was adopted, if applicable

Name of proposed Alternative Retirement Program: Kentucky Employers' Mutual Retirement Plan

Type of Plan: Defined Benefit and Defined Contribution

*Attach documentation of alternative retirement plan***If the agency is a corporation organized under KRS Chapter 273:**

Secretary of State Organization Number: N/A

Name of Registered Agent: Jon Stewart

Address: 250 West Main, Suite 900	City: Lexington	State: KY	Zip Code: 40507
-----------------------------------	-----------------	-----------	-----------------

Attach copies of Articles of Incorporation, By-Laws, Certificate of Existence/Authorization, if applicable

Attach the following information for all current and former full time employees:

- Full names;
- Last known addresses;
- Dates of Birth;
- Social Security Numbers of Kentucky Retirement Systems Member IDs;
- Beginning dates of employment, if applicable;
- Ending dates of employment, if applicable; and
- Sick leave balances;
- Provide a list of active lawsuits, legal actions, arbitrations, mediations and other litigation, except for cases in which the employer is seeking to collect a debt owed to it by one of its members, pending to which the employer is a party including:
 - Name of the case;
 - Number of the case;
 - The name and address of the Court, arbitrator, mediator, or administrative agency in which the case is pending.

Attach a copy of the Complaint or a description of the allegations made in the Complaint as well as the type and amount of relief being sought.

Attach:

- The employer's most recent five (5) audited financial statements and independent auditor's reports;
- The employer's most recent five (5) Consolidated Annual Financial Reports, if applicable;

☒ If employer intends to pay by lump sum:

- Documentation of the employer's plan to pay the full actuarial cost including:
- Funding source;

☐ If employer intends to pay by installment payment plan:

- Documentation of the employer's plan to pay the full actuarial cost including:
- Funding source;
- List of real property owned by the employer, including deeds of conveyance, title, all liens or encumbrances on the real property and any current written contractual lease or rental agreement of the real property identified;
- List of liabilities of the employer; and inventory of all other chattel and personal property owned by the employer or in which the employer has an interest that may be used as collateral by the employer, including a description of the property, the location of the property, and an estimated value;
- Proposed Detailed Financing Statement, if the employer intends to pay in installments;

Name of Attorney preparing Detailed Financing Statement:

Address:

City:

State:

Zip Code:

Phone Number:

Fax:

E-mail:

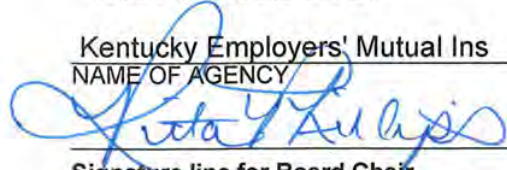
I, Jon Stewart, President/CEO acknowledge
NAME OF AGENCY HEAD TITLE OF AGENCY HEAD

and agree that Kentucky Employers' Mutual Ins is subject to and will comply with all the provisions KRS 61.552 and
NAME OF AGENCY
KAR 1:145.


Signature line for Agency Head

I, Rita Phillips, Chair of the Board of Trustees, acknowledge and agree that
NAME OF BOARD CHAIR

Kentucky Employers' Mutual Ins is subject to and will comply with all the provisions KRS 61.552 and 105 KAR 1:145.
NAME OF AGENCY


Signature line for Board Chair

RM



JPMorgan Chase Bank, N.A.
Louisville, KY

10042541

21-13/830

250 West Main Street, Suite 900
Lexington, KY 40507

DATE: 12/18/2015

AMOUNT: Ten Thousand And 00/100 Dollars

AMOUNT
\$10,000.00

COPY

PAY TO THE ORDER OF Kentucky Retirement Systems
1260 Louisville Road
Perimeter Park West
Frankfort KY 40601

Jon Stewart
VOID IF NOT PRESENTED WITHIN 90 DAYS

⑈0010042541⑈ ⑆083000137⑆ 591955252⑈

INVOICE NO
CKRQ2-121715KRS

VENDOR ID
KRS

INVOICE DESCRIPTION

INVOICE TOTAL
\$10,000.00

Kentucky Employers' Mutual Insurance
Application for Voluntary Cessation from KERS
Form 7730

BOARD OF DIRECTORS
AS OF DECEMBER 1, 2015

Ms. Rita Phillips, Chair
8109 Bohannon Station Rd.
Louisville, KY 40291

Mr. Mark Workman, Vice Chair
500 South 17th St.
Paducah, KY 42003

Mr. Sam Newcomb, Secretary
105 Wimbledon
Frankfort, KY 40601

Mr. John Caudill
P O Box 1099
Hindman, KY 41822

Ms. Debra Nicholson
302 Coralberry Rd.
Louisville, KY 40207

Mr. Marvin Russow
12514 Valley Pine Drive
Louisville, KY 40299

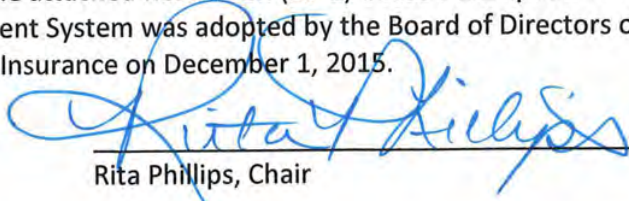
Mr. David H. Snowden
Triangle Talent, Inc.
10424 Watterson Trail
Louisville, KY 40299

Ms. Lori Flanery
Secretary, Finance and Admin Cabinet
Room 383, Capitol Annex
Frankfort, KY 40601

Ms. Dinah Bevington
Acting Secretary, Personnel Cabinet
501 High St., 3rd Fl
Frankfort, KY 40601

Mr. Larry Roberts
Secretary, Labor Cabinet
1047 US Hwy 127 S
Frankfort, KY 40601

I hereby certify that the attached Resolution (15-1) Cease Participation in the Kentucky Employees Retirement System was adopted by the Board of Directors of Kentucky Employers' Mutual Insurance on December 1, 2015.



Rita Phillips, Chair

STATE OF KENTUCKY}
COUNTY OF FAYETTE}

The foregoing Certification was acknowledged before me this the 1st day of December, 2015 by Rita Phillips, Board Chair, Kentucky Employers' Mutual Insurance.

My Commission Expires: 8-10-2016



NOTARY PUBLIC, KENTUCKY, STATE AT LARGE

SARAH KOSIN
NOTARY PUBLIC
Kentucky, State At Large
My Commission Expires 8/10/2016
I.D. # 472563



**RESOLUTION
(15-1)
CEASE PARTICIPATION IN THE
KENTUCKY EMPLOYEES RETIREMENT SYSTEM**

WHEREAS, the Board of Directors of Kentucky Employers' Mutual Insurance (KEMI) has carefully deliberated and determined that it is in the best interest of KEMI to voluntarily cease participation in the Kentucky Employees Retirement System (KERS); and

WHEREAS, in order to voluntarily cease participation in KERS the Board is required to pass a resolution to that effect;

NOW, THEREFORE, the Board of Directors of KEMI hereby RESOLVES as follows:

KEMI has decided to voluntarily cease participation in Kentucky Employees Retirement System;

KEMI acknowledges that it is subject to the requirements and restrictions of KRS 61.522 and 105 KAR 1:145;

KEMI acknowledges that in order to voluntarily cease participation in Kentucky Employees Retirement System it shall pay the full actuarial cost of withdrawal and all administrative costs;

KEMI acknowledges that its employees will no longer earn service credit in Kentucky Employees Retirement System for employment with the KEMI after KEMI's approved cessation date from Kentucky Employees Retirement System under KRS 61.522 and 105 KAR 1:145;

KEMI agrees to cooperate with Kentucky Retirement Systems to educate its employees about the effect of KEMI's cessation on their retirement accounts and their options regarding their retirement accounts; and

KEMI will not mandate, force, or require, its employees to take a refund of their accumulated account balance as defined in KRS 61.510(41) or 78.510(38) or retaliate against its employees who choose not to take refunds of their accumulated account balance as defined in KRS 61.510(41) or 78.510(38).

Rita Phillips, Chair

**Kentucky Employers' Mutual Insurance
Application for Voluntary Cessation from KERS
Form 7730**

Documentation of Alternative Retirement Plan:

Name of Proposed Alternative Retirement Program: Kentucky Employers' Mutual Insurance
Employee Retirement Plan

Type of Plan: Combination Defined Benefit (DB) and Defined Contribution (DC)

Documentation of Plan:

For those employees who choose to take a refund of their accumulated account balance, participation in the KEMI plan will be as follows:

- KERS Tier 1 employees: A subset of this group of employees (based on age and years of service) will move to the DB plan and will have the option of voluntarily contributing to the DC plan. The remaining Tier 1 employees will have the option of participating in the DB plan or the DC plan.
- KERS Tier 2 and 3 employees: These employees will move to the DC plan.
- New hires will participate in the DC plan.

Those employees who choose to leave their accumulated account balance at KERS will be eligible to voluntarily participate in the DC plan.

**BYLAWS
OF
KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY**

ARTICLE I - NAME

Pursuant to KRS 342.803, the name of this non-profit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth is KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY (hereinafter referred to as "KEMI"). KEMI will engage in any and all business authorized by KRS Chapter 342 and KRS Chapter 304.

ARTICLE II - PRINCIPAL OFFICE

The principal office and place of business of KEMI shall be Lexington, Kentucky.

ARTICLE III – MEMBERS PARTICIPATION

Each policyholder is a member of KEMI during the period insured and no longer. Members shall share in the earnings of KEMI in such manner, at such time, and in such amounts, as may be determined from time to time by the Board of Directors (hereinafter "Board"). In the event of the liquidation and dissolution of KEMI, voluntary or otherwise, the surplus funds shall be the property of the members and the members shall share in the distribution of said surplus in such manner, at such time and in such amount as may be determined by the applicable laws of the Commonwealth of Kentucky.

ARTICLE IV - MEMBER MEETINGS

Annual meetings and special meetings of the members shall be governed by the applicable provisions of KRS 304.24-160 to KRS 304.24-210, and by any other applicable provisions of KRS Chapter 304.24.

ARTICLE V - BOARD OF DIRECTORS

Section 1. Board Members. Pursuant to KRS 342.807, a Board of Directors shall govern KEMI. The Board shall have those powers and duties set forth in KRS 342.801 - KRS 342.843.

Section 2. Compensation of Directors. Compensation for the Members of the Board shall be as defined in KRS 342.809.

Section 3. Removal of Board Member. Pursuant to KRS 342.809, a board member, except the secretaries of the cabinets, may be removed for cause by a vote of at least a two-thirds (2/3) majority of the total members of the Board. Cause shall include, but not be limited to, incompetence or misconduct. Incompetence shall be defined as lack of ability, legal qualification, or physical, intellectual, or moral fitness to discharge the required duties of a board member. Moral fitness requires that board members refrain from any business or personal behavior which might be viewed unfavorably by current or potential customers or the public at large. Misconduct shall include, but not be limited to, acts which the board member had no right to perform, acts performed improperly, failure to act in the face of an affirmative duty to act and any violation(s) of the Duty of Loyalty or Duty of Care owed by the Board to the organization. Any discussion related to the removal or possible removal of a Board member shall be conducted in a closed meeting of the Board pursuant to KRS 342.841(1).

ARTICLE VI - MEETINGS

Section 1. Open Meetings. Pursuant to KRS 342.841 all meetings of the Board shall be subject to the applicable provisions of KRS Chapter 61 and the exceptions contained therein as well as the exceptions contained in KRS 342.841.

Section 2. Regular Meetings. Regular meetings of the Board shall be held at the time and place as fixed by the Board through Resolution in accordance with the meeting frequency specified in KRS 342.809 and with the provisions of KRS 61.820. If a meeting is not expected to have a quorum of members present, the Board Chairperson or Vice-Chairperson may cancel the meeting. With the approval of all members present at a given meeting, any scheduled meeting may be advanced or postponed to a later date. A rescheduled meeting is a special meeting subject to the provisions of KRS 61.823.

Section 3. Committee Meetings. Committees may meet at any time prior to or following a regularly scheduled Board meeting, at the location specified for that board meeting. Committees may meet at other times and places as designated by the Committee chairperson subject to the provisions of KRS 61.823 regarding special meetings.

Section 4. Special Meetings. The provisions of KRS 61.823 shall govern special meetings of the Board.

Section 5. Place of Meeting. All meetings of the Board or Committees shall be held at the principal office of KEMI or at other places within the Commonwealth as may be designated by the Chairperson.

Section 6. Notice of Meetings. The KEMI Manager/CEO, or designee, shall cause notice to be given to each member of the Board either by hand-delivery, telephone, mail, or other written or electronic means of communication, five (5) days before any

regular Board or Committee meeting and at least twenty four (24) hours prior to the time of a special meeting. The notice shall provide the time and place for the meeting and in the case of special meetings, the agenda.

Section 7. Quorum. At all meetings of the Board, a quorum shall consist of a majority of the members of the Board, and a majority of the quorum shall decide any matters coming before the meeting. Cabinet Secretaries may be represented by proxy, which shall be filed with the Chairperson or Secretary, and who may be given full power to vote.

Section 8. Minutes. Minutes shall be kept of all regular and special meetings, including committee meetings, and shall show the names of the directors who are present and a statement of each matter brought before the Board for consideration, together with a record of the Yes and No votes thereon.

Section 9. Order of Business. The order of business at the regular meetings and so far as is practical at all other meetings of the Directors shall be as follows:

- (1) Calling meeting to order;
- (2) Proof of Notice of Meeting;
- (3) Reading of and action on minutes;
- (4) Report of the Manager/CEO;
- (5) Reports of Committees;
- (6) Unfinished business;
- (7) New Business; and,
- (8) Adjournment.

Section 10. Closed Session. Closed sessions may be held in the manner and for the purposes cited in KRS Chapter 61 and KRS 342.841.

Section 11. Rules of Order. Robert's Rules of Order, latest edition, shall be recognized as the authority governing all meetings of the Board when not in conflict with these Bylaws.

ARTICLE VII - OFFICERS OF THE BOARD

Section 1. Election of Officers. The Board at its April meeting, or the next meeting thereafter if the April meeting is not held, shall elect from the members, except ex officio members, a Chairperson, a Vice Chairperson, and a Secretary. In addition, the Board, in its discretion, may elect any other officers as the Board shall, from time to time, determine. Officers shall serve until their respective successors are chosen or until their resignation or removal.

Section 2. Removal of Officer. Any officer elected by the Board may be removed at any time with or without cause by the affirmative vote of the majority of the Board.

Section 3. Vacancies. If the office of any officer or officers becomes vacant for any reason, the vacancy may be filled by the affirmative vote of the majority of the Board of Directors.

Section 4. Chairperson. The Chairperson of the Board shall preside at all meetings of the Board. The Chairperson shall have general oversight and supervision over the business, administration, and affairs of the Board. The Chairperson may sign bills, notes, checks, contracts or other instruments which the Board has authorized to be executed. The Chairperson shall also possess and perform such other duties as may be prescribed from time to time by a majority of the Board. The Chairperson, with the Secretary, shall sign the minutes of all Board meetings over which he or she may have presided.

Section 5. Vice Chairperson. In the absence of or the disability of the Chairperson of the Board, the Vice-Chairperson shall possess and perform the duties of the Chairperson. The Vice-Chairperson shall also possess and perform such other duties as may be prescribed from time to time by a majority of the Board.

Section 6. Secretary. The Secretary shall assure that minutes are kept of all meetings of the Board and all votes by Board members are recorded. The Secretary shall give or cause to be given notice to other members of all Board meetings and shall be custodian of all the records of the Board. The Secretary shall also possess and perform such other duties as may be prescribed from time to time by a majority of the Board.

Section 7. Committees. Standing committees and committee chairpersons may be appointed by the Board Chairperson for purposes as are necessary to carry out the duties of the Board. The Board Chairperson may also appoint other committees as circumstances require. The Board Chairperson may remove members from and fill vacancies on any committee. The Board Chairperson may be an ex officio member of all committees of the Board.

ARTICLE VIII- CONTRACTS

The Board may authorize the Manager/CEO to enter into any contract or execute and deliver any contracts or other instruments in the name of and on behalf of KEMI.

ARTICLE IX – ACCOUNTS

Section 1. The Board shall cause true and complete accounts to be kept of all transactions and of all assets and liabilities of KEMI in accordance with the accounting principles applicable to KEMI. The Board shall also cause such books and records to be kept as are necessary to comply with all requirements of statutes and regulations that are applicable to KEMI.

Section 2. The books of account shall be kept at the principal office KEMI or at such other place as the Board shall from time to time determine, and shall always be open to inspection.

Section 3. All checks, drafts or other orders for the payment of money, notes or other evidences of indebtedness issued in the name of the KEMI shall be signed by such officer or officers, agent or agents of KEMI and in such manner as shall from time to time be determined by the Board.

Section 4. Fidelity or Financial Institution Protection. The Board shall purchase fidelity or financial institution bond(s) to cover the officers and employees of KEMI handling its funds in such amounts as may be reasonable.

ARTICLE X - CONFLICT OF INTEREST

Section 1. Executive Branch Code of Ethics. Pursuant to KRS 342.837, the Board, the Manager/CEO, all Officers, and employees of KEMI shall comply with the Executive Branch Code of Ethics, KRS Chapter 11A, and no member of the Board shall have any direct or indirect interest in any undertaking that puts the member's personal interest(s) in conflict with that of KEMI.

Section 2. Confidential Information. No Board Director or Officer, in order to further his/her own economic interest, or those of any other person, or for any other purpose shall knowingly disclose or use confidential information acquired in the course of his/her official duties with the Board or KEMI.

ARTICLE XI – INDEMNIFICATION

Section 1. Indemnification. The provisions of KRS 342.835 and any applicable provisions of KRS Chapter 304 pertaining to Domestic Mutual Insurers shall apply to KEMI. The Board shall indemnify each person who is or has been a member of the Board, the Manager/CEO, or an employee of KEMI against expenses, including attorney fees, judgments, fines, and amounts paid in settlement, actually and reasonably incurred by the person, for acts or omissions committed by the person that are determined by the Board to be within the scope of that person's official capacity as a Board member, Manager/CEO, or employee of KEMI, to the fullest extent to which that person may be indemnified under KRS 342.835.

Section 2. Insurance. The Board may purchase and maintain insurance on behalf of any person who may be indemnified to the extent of that person's right to indemnity under this article.

ARTICLE XII - SEVERABILITY

The invalidity or unenforceability of any provision of these bylaws shall not affect the validity or enforceability of the remaining provisions.

ARTICLE XIII - ASSESSMENTS AND DIVIDENDS

Section 1. Assessments. As authorized by KRS 342.823 (5) the Board may levy an assessment on its policyholders if the assets of KEMI are less than its liabilities. Any assessment must be done in the manner provided in subtitle 24 of KRS Chapter 304. The Board may assess on any policyholders by class or classes should the source of the liability be attributable to those class or classes or it may assess all policyholders. The Board may secure the services of actuarial consultants in making its decision.

Section 2. Dividends. As authorized by KRS 342.819 the Board may, on an annual basis, declare a dividend. Such declaration shall be in accordance with subtitle 24 of KRS Chapter 304.

ARTICLE XIV - AMENDMENT OF BYLAWS

These bylaws may be adopted, amended or repealed by the affirmative vote of a majority of the Board at any meeting, provided notice of the proposed adoption, amendment or repeal is contained in the notice of such meeting.

Adopted this 11th day of June, 2013.


Chairperson

ATTEST: 
Secretary

Bylaws
June 2013

342.801 Legislative findings and intent.

- (1) The General Assembly finds and declares that:
 - (a) An adequate and available workers' compensation insurance market does not exist for employers in the Commonwealth;
 - (b) Approximately fifty percent (50%) of the private workers' compensation insurance market resides in the residual market mechanism for workers' compensation;
 - (c) The voluntary insurance market has declined to the point that employers in the Commonwealth, who lack the financial capability to cover their own risk, have few insurance options except the residual market mechanism through which to maintain their statutorily-required workers' compensation coverage;
 - (d) A lack of an adequate market for workers' compensation insurance threatens the economic welfare of the Commonwealth and its ability to create and maintain jobs for the citizens of Kentucky;
 - (e) Employers in the Commonwealth and other states are required by law to provide workers' compensation coverage to their employees and, therefore, the General Assembly has a responsibility to ensure employers an available and adequate insurance mechanism through which employers may discharge their statutory duty regarding workers' compensation; and
 - (f) State funds have historically and traditionally been a viable participant in the workers' compensation insurance market, that workers' compensation state funds exist in twenty-five (25) states, and that at least seven (7) states have created competitive state funds since 1983.
- (2) Therefore, it is the intent of the General Assembly in creating the Employers' Mutual Insurance Authority to establish a self-supporting competitive state fund for the purpose of providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage required under this chapter.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, sec. 39, effective April 4, 1994.

342.803 Kentucky Employers' Mutual Insurance Authority.

- (1) The Kentucky Employers' Mutual Insurance Authority is created as a nonprofit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth which shall be a public body corporate and politic to insure employers in the Commonwealth for workers' compensation, employers' liability insurance and coverage required by the Federal Coal Mine Health & Safety Act, the Jones Act, and the Longshore and Harbor Workers Act incidental to and written in conjunction with workers' compensation. The General Assembly hereby recognizes that the operation of a competitive state fund is a unique activity for state government and that a corporate structure will best enable the authority to be managed in an entrepreneurial and business-like manner. The authority shall function in a manner similar to a governing board for a domestic mutual insurance company and shall be subject to the provisions of KRS Chapter 304 applicable to domestic mutual insurance companies, unless otherwise provided or exempted in KRS 342.801 to 342.843.
- (2) Except for initial funding for start-up, the authority shall be entirely self-supporting.
- (3) The authority or its liabilities shall not be deemed to constitute a debt or a liability of the Commonwealth or a pledge of the faith and credit of the Commonwealth.
- (4) The authority shall provide coverage and issue policies as an insurer in the voluntary market and as an insurer of last resort.

Effective: July 15, 1998

History: Amended 1998 Ky. Acts ch. 361, sec. 1, effective July 15, 1998. -- Amended 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 39, effective December 12, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 40, effective April 4, 1994.

342.805 Definitions for KRS 342.801 to 342.843.

As used in KRS 342.801 to 342.843, unless the context otherwise requires:

- (1) "Authority" means the Kentucky Employers' Mutual Insurance Authority.
- (2) "Board" means the board of directors of the authority.
- (3) "Insurer of last resort" means an entity that provides workers' compensation coverage to any and all employers who comply with the provisions of KRS 342.801 to 342.843 for their business in and incidental to the Commonwealth.
- (4) "Manager" means the manager of the authority.
- (5) "Policyholder" means an employer in the Commonwealth or an employer with an employee or employees in the Commonwealth who has secured and maintains workers' compensation coverage under this authority.

Effective: December 12, 1996

History: Amended 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 40, effective December 12, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 41, effective April 4, 1994.

342.807 Board of directors.

- (1) The authority shall be governed by a board of directors. The board shall exercise complete jurisdiction over the authority.
- (2) The board shall consist of the:
 - (a) Secretary of the Finance and Administration Cabinet;
 - (b) Secretary of the Personnel Cabinet;
 - (c) Secretary of the Labor Cabinet; and
 - (d) Seven (7) at-large members appointed by the Governor, subject to confirmation by the Senate.
- (3) Any vacancy which occurs prior to the expiration of a term shall be filled by the Governor in the same manner as the initial appointment was made, and the new appointee shall serve only the remainder of the unexpired term.
- (4) No person shall serve on the board who:
 - (a) Fails to meet or comply with the conflict of interest policies established by the board and KRS 304.24-270;
 - (b) Is not bondable;
 - (c) Is an employee, attorney, or contractor of a competing insurer providing workers' compensation insurance in the Commonwealth; or
 - (d) Is not a resident of this Commonwealth.
- (5) In making the appointments to the board, subject to Senate confirmation, the Governor shall ensure adequate representation from the major sectors of the economy and workforce in the Commonwealth.

Effective: July 15, 2010

History: Amended 2010 Ky. Acts ch. 24, sec. 1854, effective July 15, 2010. -- Amended 1998 Ky. Acts ch. 361, sec. 2, effective July 15, 1998. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 42, effective April 4, 1994.

342.809 Election of officers -- Quorum -- Compensation -- Ex officio members of board.

- (1) The board shall elect a chair and other officers it deems necessary from its members. The Governor shall make the initial appointments to the board as follows: three (3) members shall be appointed to terms that expire December 31, 1995, and four (4) members shall be appointed to terms that expire December 31, 1997. Subsequent members shall serve terms of four (4) years and shall serve until their successors are appointed and qualified.
- (2) Senate confirmation of the Governor's appointees is required in accordance with the provisions of KRS 11.160. If a member is not confirmed by the Senate, the Governor, within thirty (30) days of the rejection, shall make another appointment. That member shall serve the remainder of the term in question and shall also be subject to confirmation should the term extend until the next regular session, or a special session which includes this subject on the call, whichever occurs earlier.
- (3) Six (6) members shall constitute a quorum. The board shall meet at least quarterly and at such other times as the chair may determine. The board shall also meet upon the call of four (4) or more of the members of the board.
- (4) On July 15, 1998, each member, except the secretaries of the cabinets, shall be compensated eight thousand five hundred dollars (\$8,500) annually, and beginning on July 15, 1999, twelve thousand dollars (\$12,000) annually. In addition, the members of the board, except the secretaries of the cabinets, shall be reimbursed for necessary travel and lodging expenses in accordance with administrative regulations promulgated by the Cabinet for Finance and Administration for state employees.
- (5) A board member, except the secretaries of the cabinets, may be removed for cause by the board. Cause shall include, but not be limited to, incompetence or misconduct defined in policies or bylaws adopted by the board.

Effective: June 21, 2001

History: Amended 2001 Ky. Acts ch. 73, sec. 1, effective June 21, 2001. -- Amended 1998 Ky. Acts ch. 154, sec. 94, effective July 15, 1998; ch. 361, sec. 3, effective July 15, 1998; and ch. 394, sec. 1, effective July 15, 1998. -- Amended 1996 Ky. Acts ch. 194, sec. 63, effective July 15, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 43, effective April 4, 1994.

Legislative Research Commission Note (7/15/98). This section was amended by 1998 Ky. Acts chs. 154, 361, and 394. Where these Acts are not in conflict, they have been codified together. Where a conflict exists between Acts chs. 154 and 361, Acts ch. 361, which was last enacted by the General Assembly, prevails under KRS 446.250.

342.811 Powers and duties of board.

The board of directors of the authority shall function in a manner similar to the governing body of a mutual insurance company established pursuant to KRS Chapter 304, with all of the general corporate powers incidental thereto. The powers and duties of the board shall include, but not be limited to, the power to:

- (1) Sue;
- (2) Hire a manager to administer the authority in accordance with the policies and procedures of the board;
- (3) Hire an internal auditor who shall serve at the pleasure of and report directly to the board on the internal operations of the authority;
- (4) Adopt a corporate seal;
- (5) Develop and file with the Legislative Research Commission bylaws for the operation of the authority;
- (6) Develop bylaws to establish the contingent liability of the policyholders for assessment purposes required in KRS 342.823;
- (7) Examine and adopt an annual operating budget for the authority;
- (8) Serve as investment trustees and fiduciaries of the authority in accordance with the provisions of KRS Chapter 386;
- (9) Incur debt in its own name and enter into financing agreements with the Commonwealth, its own agencies, or with a commercial bank, excluding the authority to issue bonds;
- (10) Develop policy for the operation of the authority consistent with its mission and fiduciary responsibility;
- (11) Adopt a procurement policy consistent with the provisions of KRS Chapter 45A, including competitive bidding procedures;
- (12) Develop and publish an annual report to policyholders, the Governor, the General Assembly, and interested parties that describes the financial condition of the authority, including a statement of expenses, income, and actuarial soundness;
- (13) Pursuant to KRS Chapter 304, determine and establish an actuarially-sound price for insurance offered by the authority, including any dividends or deviations;
- (14) Pursuant to KRS 342.823, assess policyholders;
- (15) Employ a qualified firm to conduct an internal review and management or performance audit of the internal operations of the authority as needed or determined by the board, Attorney General, or Auditor of Public Accounts;
- (16) Approve a personnel policy subject to the provisions of KRS 342.813;
- (17) Approve all contracts entered into by the authority, in accordance with the bylaws and procurement policy of the board;
- (18) Conduct annually an independent audit of the financial condition of the authority; and
- (19) Perform all other acts necessary or convenient in the exercise of any power, authority, or jurisdiction over the authority, either in the administration or in

connection with the business of the authority to fulfill the purpose of KRS 342.801 to 342.843.

Effective: July 15, 1998

History: Amended 1998 Ky. Acts ch. 361, sec. 4, effective July 15, 1998. -- Amended 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 41, effective December 12, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 44, effective April 4, 1994.

342.813 Manager -- Qualifications -- Powers and duties -- Bond.

- (1) Following a nationwide search, the board shall hire a manager, subject to Senate confirmation in accordance with KRS 11.160 who shall serve at the pleasure of the board. The manager shall be compensated at a level determined by the board.
- (2) The manager shall have proven successful experience for a period of at least five (5) years as an executive at the general management level in insurance operations or in the management of a state fund for workers' compensation.
- (3) The manager shall conduct the day-to-day operations of the authority for the purpose of carrying out the policies and procedures of the board. The duties of the manager include, but are not limited to:
 - (a) Administering all operations of the authority in accordance with the direction of the board;
 - (b) Recommending to the board an annual administrative budget covering the operations of the authority and, upon approval, submitting the administrative budget, financial status, and actuarial condition of the authority to the Governor and the General Assembly for their examination;
 - (c) Directing and controlling all expenditures of the approved budget;
 - (d) From time to time, upon the recommendation of an actuary, recommending to the board actuarially-sound rating plans, and the amount of dividends, if any, to be returned to policyholders;
 - (e) Investing the assets of the authority under the guidance of the board and in accordance with the provisions of Subtitle 7 of KRS Chapter 304;
 - (f) Recommending to the board and administering a system of personnel administration;
 - (g) Preparing and administering fiscal, payroll, accounting, data processing, and procurement procedures for the operation of the authority;
 - (h) Recommending to the board bylaws and uniform procedures for the management of the authority;
 - (i) Within the limitations of the budget, employing necessary staff personnel in accordance with the personnel policies of the board;
 - (j) Maintaining appropriate levels of property, casualty, and liability insurance as approved by the board to protect directors, officers, employees, and assets of the authority; and
 - (k) Contracting in accordance with KRS 342.811 for claims administration, safety services, legal defense, actuaries, medical providers, financial services, and other services which the manager elects to obtain outside employed staff.
- (4) The manager may:
 - (a) Reinsure any risk or part of any risk;
 - (b) Cause to be inspected and audited the payrolls of policyholders or employers applying to the authority for insurance;
 - (c) Establish procedures for adjusting claims in accordance with this chapter; and

- (d) Require policyholders to maintain an adequate deposit to provide security for periods of coverage for which premiums have not been paid.
- (5) The manager shall give an official bond in an amount and with sureties approved by the board. The premium for the bond shall be paid by the authority.
- (6) The provisions of KRS Chapters 18A and 64 shall not apply to the board, the manager, or the staff of the authority; however, the board shall adopt a system of personnel administration that includes benefits, grievance procedures, training and compensation.

Effective: July 15, 1998

History: Amended 1998 Ky. Acts ch. 361, sec. 5, effective July 15, 1998. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 45, effective April 4, 1994.

342.815 Insurance coverage provisions.

- (1) The authority may provide coverage for insurance, authorized in KRS 342.803, to any employer in the Commonwealth, and who tenders the required premium for coverage and comply with other conditions and qualifications for obtaining and maintaining coverage adopted by the authority to protect and ensure its actuarial soundness and solvency.
- (2) The authority shall provide coverage to any employer who is unable to secure coverage in the voluntary market unless the employer owes undisputed premiums to a previous workers' compensation carrier or to a workers' compensation residual market mechanism.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 46, effective April 4, 1994.

342.817 Rating plans, rates, and underwriting standards for different classes of risks -- Competitive nature and filing requirement for rates -- Annual report on status of surplus.

- (1) The authority, through its board and manager, shall establish separate rating plans, rates, and underwriting standards for different classes of risks for the authority.
- (2) The rating plans, rates, and underwriting standards developed for the categories of risk shall be based on generally accepted actuarial practices and procedures as set forth in the Statement of Principles Regarding Property and Casualty Ratemaking of the Casualty Actuarial Society, in accordance with the actuarial standards of practice and compliance guidelines of the Actuarial Standards Board. The rates shall be actuarially sound for both the voluntary market and the market of last resort and set at levels which are expected, in the aggregate, to be sufficient to pay all workers' compensation claims incurred by the participating employer risks and other permitted expenses of the authority. The rates for the voluntary market and the market of last resort shall be filed individually with the commissioner of the Department of Insurance on forms prescribed by the commissioner by the promulgation of administrative regulations.
- (3) Multitiered premium or rating plans may be developed to provide workers' compensation coverage to insureds in the Commonwealth.
- (4) The manager shall develop statistical and other information as necessary to distinguish its writings in the voluntary market, and its writings as a market of last resort.
- (5) The rates established by the authority for its policyholders shall be based only on Kentucky loss experience data, except that other loss experience data may be utilized as a supplement to Kentucky data if supplemental or additional data are necessary to establish statistical credibility of an employment classification.
- (6) Any and all rates, whether for the voluntary market or the market of last resort, established by the board are deemed competitive and shall be filed with the commissioner of insurance in accordance with KRS Chapter 304 in the same manner as any other mutual insurance company writing workers' compensation in the Commonwealth.
- (7) Notwithstanding any provision of KRS Chapter 304 to the contrary, the surplus requirements for mutual insurance companies in the Commonwealth shall not apply to the authority until the authority has been in operation for eighty-four (84) months, unless modified by the General Assembly. In addition to other reporting requirements in KRS 342.809 and 342.821, the authority shall report to the Labor and Industry Committee of the General Assembly, no later than October 31 of each year, on the status of its efforts to build and maintain a surplus as required by KRS Chapter 304.

Effective: July 15, 2010

History: Amended 2010 Ky. Acts ch. 24, sec. 1855, effective July 15, 2010; and ch. 166, sec. 15, effective July 15, 2010. -- Amended 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 42, effective December 12, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 47, effective April 4, 1994.

Legislative Research Commission Note (7/15/2010). This section was amended by 2010 Ky. Acts chs. 24 and 166, which do not appear to be in conflict and have been codified together.

Legislative Research Commission Note (7/15/2010). References to the "Office of Insurance" and the "executive director" of insurance in subsection (2) of this section, as amended by 2010 Ky. Acts ch. 166, sec. 15, have been changed in codification to the "Department of Insurance" and the "commissioner" of insurance, respectively, to reflect the reorganization of certain parts of the Executive Branch, as set forth in Executive Order 2010-535 and confirmed by the General Assembly in 2010 Ky. Acts ch. 24. These changes were made by the Reviser of Statutes pursuant to 2010 Ky. Acts ch. 24, sec. 1938.

Legislative Research Commission Note (12/12/96). The reference to KRS 342.809 that was created in subsection (7) of this statute by 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 42 appears to be erroneous. It seems likely that a reference to KRS 342.811 may have been intended.

342.819 Dividends.

On an annual basis, the board may declare a dividend in accordance with Subtitle 24 of KRS Chapter 304, and distribute the same in the form of premium discounts, dividends, or a combination of dividends and discounts, at its discretion, if:

- (1) The funding obtained pursuant to KRS 342.829 has been repaid in full;
- (2) An independent actuarial report of the prior year's operations has been completed and reviewed by the board;
- (3) The authority has met all expenses for administration and claims for the prior year; and
- (4) Adequate reserves exist to pay all claims.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 48, effective April 4, 1994.

342.821 Quarterly reports of assets and liabilities.

On a quarterly basis, the manager shall prepare a report of assets and liabilities, which shall also include a statement of condition regarding the solvency of the authority when awarded claims to date, and estimated initial claims not reported, are taken into account. This report shall be a public record and shall be provided to the board, the Governor, and the Legislative Research Commission.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 49, effective April 4, 1994.

**342.823 Discounting not to be used in determining solvency -- Authority's reports -
- Annual statement of solvency -- Circumstances permitting contract audit
with certified public accountant -- Discretionary levy and enforcement of
assessments.**

- (1) In determining the solvency of the authority in regard to maintaining adequate reserves, the commissioner of insurance, the independent accountant engaged for the annual audit, and the board, in exercising its prudent stewardship, shall not utilize the practice of "discounting" the funds to reduce future liabilities, except in conformity with standards or rules promulgated by the National Association of Insurance Commissioners.
- (2) The authority shall file reports required by KRS 304.3-240.
- (3) The authority shall file a report not later than March 31 of each year indicating the business done by the authority during the previous year, including a balance sheet showing assets and liabilities at the beginning and conclusion of that year. The report shall be a public record and shall be delivered to the Governor, commissioner of insurance, Auditor of Public Accounts, Attorney General, and the co-chairs of the Legislative Research Commission. Additionally, a statement of solvency shall be prepared which shall include, at a minimum:
 - (a) A summary of the prior quarterly reports required in KRS 342.821;
 - (b) A management projection of the future solvency status for the authority; and
 - (c) Any recommendations pertaining to the same.
- (4) The authority shall not enter into any contract with a certified public accountant for an audit unless the Auditor of Public Accounts has declined in writing to perform the audit or has failed to respond within thirty (30) days of receipt of a written request for an audit. Any contract with a certified public accountant entered into as a result of the Auditor of Public Accounts declining to perform the audit shall specify the following:
 - (a) That the certified public accountant shall forward a copy of the audit report and management letters to the Auditor of Public Accounts, Attorney General, and Legislative Research Commission; and
 - (b) That the Auditor of Public Accounts shall have the right to review the certified public accountant's work papers.
- (5) If at any time the assets of the authority are less than its liabilities, the board may levy an assessment on its policyholders in the manner provided in Subtitle 24 of KRS Chapter 304.

Effective: July 15, 2010

History: Amended 2010 Ky. Acts ch. 24, sec. 1856, effective July 15, 2010. -- Amended 1998 Ky. Acts ch. 361, sec. 6, effective July 15, 1998. -- Amended 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 43, effective December 12, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 50, effective April 4, 1994.

342.825 Investments.

The board shall formulate and adopt an investment policy that safeguards the value of all assets and maximizes investment potential commensurate with risk and liquidity restrictions, and supervise the investment activities of the authority subject to the limitations on domestic insurance companies under KRS Chapter 304. Notwithstanding any provisions of the Kentucky Revised Statutes to the contrary, the authority may utilize the investment expertise and advice of the Office of Financial Management in the Finance and Administration Cabinet. The authority shall also retain an independent investment counsel or managers who shall be subject to standards applicable to fiduciaries responsible for safeguarding assets of a corporation.

Effective: July 14, 2000

History: Amended 2000 Ky. Acts ch. 46, sec. 30, effective July 14, 2000. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 51, effective April 4, 1994.

342.827 Statistical and actuarial data to be maintained.

The manager shall compile and maintain statistical and actuarial data related to the determination of proper premium rate levels, the incidence of work-related injuries, costs related to those injuries, including medical and indemnity, and other data necessary for the development of fair and equitable rates and rating plans.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 52, effective April 4, 1994.

342.829 Funding of authority -- Restrictions on use of funds.

- (1) The authority shall not receive any direct state general fund appropriation.
- (2) Initial funding for the authority shall be determined by the Governor and the secretary of the Finance and Administration Cabinet. Funding methods may include, but not be limited to, a loan from an existing state agency or agencies to the authority. The maximum amount borrowed from all state agencies shall not exceed seven million dollars (\$7,000,000), to be repaid over a period not to exceed ten (10) years from the original loan date. The Governor shall have the authority to provide or secure additional funding necessary to maintain, for the first thirty-six (36) months of its operation, the surplus the Governor deems proper. The additional funding may come from any funds which may be expended directly by the Governor or from nonstate-agency sources and, regardless of source, shall be a loan to the authority. The rate of interest to be applied to the loan shall be one percent (1%) higher than the average for the long-term investment folder of the lending agency on the anniversary date of the original loan. The interest rate shall be adjusted annually on the anniversary date of the original loan. To minimize cash requirements and interest obligations, the loan shall be executed as a line of credit against the lending agency, so that only those funds actually required for initial start-up operations, including the establishment of a surplus and reinsurance expenses, are drawn down on an "as needed" basis.
- (3) Any executive branch agency of the Commonwealth and any public corporation created by the Commonwealth, any statute to the contrary notwithstanding, may lend money to the authority subject to the terms and conditions of this section, and any loan made pursuant to this section shall not be construed as a breach or violation of fiduciary duties contained in KRS Chapter 386.
- (4) Funds collected by the authority shall not:
 - (a) Be loaned to the Commonwealth or any instrumentality or agency thereof;
 - (b) Be subject to transfer to the Commonwealth or any agency or instrumentality thereof, except for repayment of the loan authorized in subsections (2) and (3) of this section; or
 - (c) Be expended for any other purposes than as authorized by KRS 342.801 to 342.843 and KRS 304.13-340.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 53, effective April 4, 1994.

342.831 Marketing and sales agents -- Commissions.

- (1) For marketing and sales purposes, the authority shall utilize only agents duly and legally licensed and in good standing in accordance with the provisions of KRS Chapter 304 to sell coverage provided by the authority. The authority shall not be required to appoint agents.
- (2) Commissions paid for marketing or sales by an insurance agent shall be determined by the manager, subject to the approval of the board.

Effective: June 24, 2003

History: Amended 2003 Ky. Acts ch. 168, sec. 1, effective June 24, 2003. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 54, effective April 4, 1994.

342.833 Workplace safety program for policyholders -- On-site examinations.

- (1) The manager shall formulate, implement, and monitor a workplace safety program for all policyholders.
- (2) The manager shall develop a written workplace accident and injury reduction plan that promotes safe working conditions and which is based upon clearly stated goals and objectives. The manager or employees of the authority shall have reasonable access to the premises of any policyholder or applicant during regular working hours.
- (3) The manager or board shall refuse to insure or shall terminate the insurance of any policyholder who refuses to permit on-site examinations or who disregards or fails to comply with workplace safety goals and objectives required by the authority as conditions for obtaining and maintaining coverage.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 55, effective April 4, 1994.

342.835 Board member, manager, or employee exempt from personal liability for official acts.

No member of the board, the manager, or any employee of the authority shall be held personally liable for any act performed or for any contract or other obligation entered into or undertaken in an official capacity, in connection with the administration, management, or conduct of the authority, its funds and other assets, its business, or other related affairs.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 56, effective April 4, 1994.

342.837 Compliance with Executive Branch Code of Ethics -- Conflicts of interest.

- (1) The board, manager, and employees shall comply with the code of ethics applicable to the Executive Branch pursuant to KRS Chapter 11A.
- (2) In addition to compliance with the code of ethics required in subsection (1) of this section, no member of the board shall have any direct or indirect interest in any undertaking that puts the member's personal interest in conflict with that of the authority. A personal interest shall include, but not be limited to, an interest in a major procurement.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 57, effective April 4, 1994.

342.839 Applicability of specified provisions of law.

- (1) Notwithstanding any provision of KRS Chapter 304 to the contrary, the authority shall be exempt from participation, and shall not join, contribute financially to, nor be entitled to the protection of, any plan, pool, association, guarantee, or insolvency fund authorized or required by KRS Chapter 304.
- (2) Except as provided in subsection (1) of this section, the authority shall be subject to the same assessments applicable to workers' compensation premiums as domestic mutual insurance companies licensed to do business in the Commonwealth and governed by the provisions of Subtitle 24 of KRS Chapter 304.
- (3) Notwithstanding the provisions of Subtitle 24 of KRS Chapter 304 or any other provisions of the Kentucky Revised Statutes to the contrary, the minimum number of directors and procedures required for incorporating a mutual insurance company, requirements relating to the name of a mutual insurance company, and any licensing requirements applicable to mutual insurance companies shall not apply to the authority.
- (4) The authority shall be considered an insurer for purposes of KRS 342.122 and other provisions of this chapter.
- (5) Notwithstanding any provision of KRS Chapter 304 to the contrary the authority shall not be subject to the provisions of Subtitle 33 or other provisions of KRS Chapter 304 that relate to the liquidation, rehabilitation, dissolution, or sale of any insurance company.

Effective: April 4, 1994

History: Created 1994 Ky. Acts ch. 181, Part 12, sec. 58, effective April 4, 1994.

342.841 Applicability of open meetings and open records provisions.

- (1) The board shall comply with KRS Chapter 61 in regard to open meetings and open records in the conduct of ordinary business. In addition to the exemptions listed in KRS Chapter 61, proceedings to discuss rates, proposed rates, or anything that relates to rates if that discussion would jeopardize the competitiveness of the authority may be closed, as well as, proceedings which would provide an unfair competitive advantage to private sector competitors providing workers' compensation coverage in the Commonwealth.
- (2) All records of the authority shall be deemed open records and subject to public inspection, unless:
 - (a) The record is excluded from inspection under KRS Chapter 61;
 - (b) The record includes information that would provide an unfair competitive advantage to private sector competitors providing workers' compensation coverage in the Commonwealth;
 - (c) In addition to the exemption provided by KRS 61.878(1)(c)1., the record is generated by the authority, generally recognized as confidential or proprietary, and which if openly disclosed would permit an unfair commercial advantage to competitors of the authority or other entity to which the record relates; and
 - (d) The record relates to a fraud investigation conducted by the authority and that does not become evidence in a criminal or civil action.

Effective: July 15, 1998

History: Amended 1998 Ky. Acts ch. 361, sec. 7, effective July 15, 1998. -- Amended 1996 (1st Extra. Sess.) Ky. Acts ch. 1, sec. 44, effective December 12, 1996. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 59, effective April 4, 1994.

342.843 Monitoring of operations of authority by Attorney General and Auditor of Public Accounts -- Report to General Assembly.

- (1) The Attorney General and the Auditor of Public Accounts shall monitor the operations of the authority.
- (2) Either the Attorney General or the Auditor of Public Accounts, or both, may make at any time any examinations or investigations, jointly or severally, of the operations, practices, management, or other matters relating to the authority as they deem necessary. Either of them shall have the power to subpoena witnesses and records for these purposes, and otherwise to compel the giving of evidence for any matter under study. The Attorney General, the Auditor of Public Accounts, or any employee authorized by either of them may require the giving of this evidence under oath and may administer the oath. Any person voluntarily providing information or evidence may be required to do so under oath administered by the Attorney General, the Auditor of Public Accounts, or any employee authorized by either of them. If any person fails or refuses to testify or furnish documentary evidence concerning any matter requested, the Franklin Circuit Court, on application of either the Attorney General or the Auditor of Public Accounts or both, may compel obedience by proceedings for contempt as in the case of disobedience of a subpoena issued from the Circuit Court or of a refusal to testify in the Circuit Court.
- (3) The Attorney General and the Auditor of Public Accounts shall have without restriction:
 - (a) Full access to all records of the authority, except that confidential medical records of employees of insureds are available only by subpoena;
 - (b) Full access to all financial transactions and investigations of the authority; and
 - (c) The right to attend all meetings of the board and its committees.
- (4) If fraud, mismanagement, illegal activity, imprudent practices, or other deficiencies are found in the operations or other practices of the authority, the Attorney General or Auditor of Public Accounts, or both shall:
 - (a) Recommend internal corrective action;
 - (b) Institute a civil action or action for injunctive relief to compel corrective action;
 - (c) Institute criminal proceedings against any officer or employee of the authority or any other person, as defined in KRS 446.010, as may be necessary; or
 - (d) Any combination of the above listed actions or any other form of action reasonably calculated to assure efficient and honest operations of the authority and those involved with it.
- (5) The Attorney General and the Auditor of Public Accounts shall report jointly to the General Assembly in January of each year in which the General Assembly convenes in an even-numbered-year regular session the results of the monitoring activities required by this section.

Effective: June 21, 2001

History: Amended 2001 Ky. Acts ch. 58, sec. 24, effective June 21, 2001. -- Amended 1998 Ky. Acts ch. 361, sec. 8, effective July 15, 1998. -- Created 1994 Ky. Acts ch. 181, Part 12, sec. 61, effective April 4, 1994.

***Kentucky Employers' Mutual Insurance
Application for Voluntary Cessation from KERS
Form 7730***

***Active Lawsuits, Legal Actions, Arbitrations, Mediations and Other Litigation Pending to Which KEMI is
a Party:***

Willet Healthcare v. KEMI 11-CI-5840. Fayette Circuit Court. Allegations of breach of contract and bad faith. No demand or information re damages sought.

KEMI v. Joash 14-CI-04544. Fayette Circuit Court. Collection action with counter-claim for fraud, conversion and breach of contract. Counter-claimant offered \$500 and agreed to dismiss counterclaim in exchange for dismissal of KEMI 's collection action.

Whitney Contracting v. KEMI 13-CI-00636. KEMI added to suit against agent for failure to provide defense to policyholder (coverage dispute). Recent award in WC claim (\$1900 plus 12% interest/annum). No determination re: coverage to date in civil suit. Recent motion to set trial date denied by Judge. Discussion among parties of case dismissal.

***Kentucky Employers' Mutual Insurance
Application for Voluntary Cessation from KERS
Form 7730***

Financial:

Most recent five (5) audited financial statements and independent auditor's reports are attached to this Application

KEMI intends to pay its full actuarial cost of voluntary cessation in a lump sum.

The lump sum payment will be made from current assets which will either be available cash or invested asset(s) that will be liquidated or a combination of both.

**Kentucky Retirement Systems**

Perimeter Park West • 1260 Louisville Rd. • Frankfort KY 40601-6124
Phone: (502) 696-8800 • Fax: (502) 696-8822 • kyret.ky.gov



Form 7725
Revised 10/2015

Request For Estimated Actuarial Cost of Voluntary Cessation**Agency Information**

Full Legal Name of Agency: Kentucky Employers' Mutual Insurance		Phone Number: 859.425.7800	
Address: 250 W. Main St., Ste 900	City: Lexington	State: KY	Zip Code: 40507
KRS Employer Code 9940			

Name of person to contact regarding this application for estimate: Jon Stewart

Address: 250 W. Main St., Ste 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859.425.7800	Fax: 859.425.7850	E-mail: jstewart@kemi.com	

Name of Agency Head: Jon Stewart

Address: 250 W. Main St., Ste 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859.425.7800	Fax: 859.425.7850	E-mail: jstewart@kemi.com	

Name of Reporting Official: Kellie Stadler

Address: 250 W. Main St., Ste 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859.425.7800	Fax: 859.425.7850	E-mail: kstadler@kemi.com	

Name of Attorney representing agency (if any): Michelle Landers

Address: 250 W. Main St., Ste 900	City: Lexington	State: KY	Zip Code: 40507
Phone Number: 859.425.7800	Fax: 859.425.7850	E-mail: mlanders@kemi.com	

This estimate of the full actuarial cost of voluntary cessation provided by Kentucky Retirement Systems will be based on unaudited information currently in Kentucky Retirement Systems' database with projections that current employees will stay employed and earn service credit until the next available cessation date and will continue to earn the same creditable compensation. Pursuant to 105 KAR 1:145, this estimate shall not be binding on Kentucky Retirement Systems and shall not be relied upon by the requesting employer.

I, Jon Stewart President & CEO acknowledge and agree
Name of Agency Head Title of Agency Head

that the estimate of the full actuarial cost of voluntary cessation to be provided by Kentucky Retirement Systems is only an estimate based on unaudited information currently in Kentucky Retirement Systems' database with projections that current employees will stay employed and earn service credit until the next available cessation date and will continue to earn the same creditable compensation. Pursuant to 105 KAR 1:145, this estimate shall not be binding on Kentucky Retirement Systems and shall not be relied upon by the requesting employer.


Agency Head Signature



JPMorgan Chase Bank, N.A.
Louisville, KY

10042540

21-13/830

250 West Main Street, Suite 900
Lexington, KY 40507

DATE: 12/18/2015

AMOUNT: Five Thousand And 00/100 Dollars

AMOUNT

\$5,000.00

COPY

PAY TO THE ORDER OF Kentucky Retirement Systems
1260 Louisville Road
Perimeter Park West
Frankfort KY 40601

Jon Stewart
VOID IF NOT PRESENTED WITHIN 90 DAYS

⑈0010042540⑈ ⑆083000137⑆ 591955252⑈

INVOICE NO
CKRQ121715KRS

VENDOR ID
KRS

INVOICE DESCRIPTION

INVOICE TOTAL
\$5,000.00

KENTUCKY EMPLOYERS' MUTUAL
INSURANCE AUTHORITY dba KENTUCKY
EMPLOYERS' MUTUAL INSURANCE
Statutory Basis Financial Statements and
Supplementary Information

*Years Ended December 31, 2014 and 2013
with Report of Independent Auditors*

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Report of Independent Auditors

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying statutory financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI), which comprise the statements of admitted assets, liabilities and policyholder surplus - statutory basis as of December 31, 2014 and 2013, and the related statements of income and changes in policyholder surplus - statutory basis, and cash flows - statutory basis for the years then ended, and the related notes to the statutory financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these statutory financial statements in accordance with the accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of statutory financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these statutory financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the statutory financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the statutory financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the statutory financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the statutory financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 2 of the financial statements, the financial statements are prepared by KEMI on the statutory basis of accounting prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky, which is a basis of accounting other than accounting principles generally accepted in the United States of America.

The effects on the financial statements of the variances between these statutory basis practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion on U.S. Generally Accepted Accounting Principles

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of KEMI as of December 31, 2014 and 2013, or the results of its operations or its cash flows for the years then ended.

Opinion on Regulatory Basis of Accounting

In our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholder surplus of KEMI as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 2.

Other Matters

Our audits were conducted for the purpose of forming an opinion on the basic statutory financial statements as a whole. The accompanying Summary Investment Schedule as of December 31, 2014, and Supplemental Investment Risks Interrogatories as of December 31, 2014 and for the year then ended (Supplementary Information) are presented for purposes of additional analysis and are not a required part of the basic statutory financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the statutory financial statements. The effects on the Supplementary Information of the variances between the statutory accounting practices and the accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material. As a consequence, the Supplementary Information does not present fairly, in conformity with accounting principles generally accepted in the United States of America, such information of KEMI as of December 31, 2014 and for the year then ended. The Supplementary Information has been subjected to the auditing procedures applied in the audit of the statutory financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the statutory financial statements or to the statutory financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Supplementary Information is fairly stated in all material respects in relation to the statutory financial statements taken as a whole.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Report of Independent Auditors, continued

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated March 30, 2015 on our consideration of KEMI's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering KEMI's internal control over financial reporting and compliance.

Dean Dotson Allen Ford, PLLC

March 30, 2015
Lexington, Kentucky

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Admitted Assets, Liabilities and Policyholder Surplus - Statutory Basis

December 31, 2014 and 2013

	<u>2014</u>	<u>2013</u>
Admitted Assets		
Long-term bonds	\$ 721,918,036	\$ 666,594,483
Common stock	74,671,394	61,167,189
Cash, cash equivalents, and short-term investments	33,226,751	41,745,787
Receivable for securities sold	3,511,596	-
Securities lending collateral reinvested	27,519,835	-
Investment income due and accrued	5,466,556	5,592,703
Premiums in course of collection	9,210,576	7,928,537
Premiums booked but deferred and not yet due	37,660,756	32,897,291
Reinsurance receivable on losses and loss adjustment expenses	86,905	75,227
Electronic data processing equipment at cost, less accumulated depreciation of \$3,437,688 and \$3,251,754 in 2014 and 2013, respectively	196,172	201,315
Receivable for retroactive reinsurance reserve assumed	<u>18,703,897</u>	<u>-</u>
Total admitted assets	<u>\$ 932,172,474</u>	<u>\$ 816,202,532</u>
Liabilities and Policyholder Surplus		
Unpaid losses	\$ 517,775,137	\$ 490,503,015
Unpaid loss adjustment expenses	44,527,898	40,758,800
Commissions payable	10,702,802	8,528,187
Unearned premiums	74,319,955	69,024,930
Amounts withheld or retained for others	6,626,525	6,208,082
Reinsurance premiums paid in advance	(671,372)	(771,055)
Remittances and items not allocated	861,347	998,786
Retroactive reinsurance reserve assumed	33,393,484	-
Payable for securities purchased	3,874,655	-
Payable for securities lending	27,519,835	-
Other liabilities	<u>4,950,450</u>	<u>4,575,246</u>
Total liabilities	723,880,716	619,825,991
Policyholder surplus	<u>208,291,758</u>	<u>196,376,541</u>
Total liabilities and policyholder surplus	<u>\$ 932,172,474</u>	<u>\$ 816,202,532</u>

See accompanying notes.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Statements of Income - Statutory Basis

Years ended December 31, 2014 and 2013

	<u>2014</u>	<u>2013</u>
Premiums earned:		
Direct	\$ 153,283,660	\$ 134,528,324
Assumed	5,181,993	4,681,713
Ceded	<u>(5,744,052)</u>	<u>(6,069,542)</u>
	152,721,601	133,140,495
Losses incurred:		
Direct	106,117,819	81,182,243
Assumed	2,897,477	2,924,543
Ceded	<u>(636,805)</u>	<u>1,395,731</u>
	108,378,491	85,502,517
Loss adjustment expenses, net of ceded	25,911,163	22,206,821
Commissions and brokerage fees	19,770,170	16,833,982
Other underwriting expenses	<u>16,631,032</u>	<u>16,353,946</u>
Total underwriting expenses	<u>170,690,856</u>	<u>140,897,266</u>
Net underwriting loss	(17,969,255)	(7,756,771)
Investment income, net of investment expenses of \$1,684,827 and \$1,941,304 in 2014 and 2013, respectively	23,397,909	23,198,095
Net realized capital gains	10,785,302	8,958,313
Bad debt and other expenses	<u>(304,456)</u>	<u>(1,148,662)</u>
Net income before policyholder dividend	15,909,500	23,250,975
Policyholder dividend	<u>3,420,959</u>	<u>6,428,792</u>
Net income	<u>\$ 12,488,541</u>	<u>\$ 16,822,183</u>

See accompanying notes.

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Statements of Changes in Policyholder Surplus - Statutory Basis

Years ended December 31, 2014 and 2013

	<u>2014</u>	<u>2013</u>
Policyholder surplus, beginning of year	\$ 196,376,541	\$ 173,093,313
Net income	12,488,541	16,822,183
Change in net unrealized gains on investments	(179,194)	5,937,754
Change in non-admitted assets	(523,430)	549,949
Change in provision for reinsurance	<u>129,300</u>	<u>(26,658)</u>
Policyholder surplus, end of year	\$ <u>208,291,758</u>	\$ <u>196,376,541</u>

See accompanying notes.

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Statements of Cash Flows - Statutory Basis

Years ended December 31, 2014 and 2013

	<u>2014</u>	<u>2013</u>
Cash flows from operating activities:		
Premiums collected, net of reinsurance	\$ 151,514,885	\$ 142,191,877
Investment income, net of investment expenses	25,416,430	24,804,834
Miscellaneous expenses	(304,455)	(1,148,662)
Benefit and loss related payments	(81,118,047)	(54,183,289)
Commissions, expenses paid and aggregate write-ins	(55,511,594)	(50,754,613)
Dividend paid to policyholders	<u>(3,420,959)</u>	<u>(6,465,850)</u>
Net cash provided by operating activities	36,576,260	54,444,297
Cash flows from investing activities:		
Proceeds from investments sold or matured	197,768,075	189,407,673
Cost of investments acquired	<u>(285,022,000)</u>	<u>(215,400,125)</u>
Net cash used in investing activities	(87,253,925)	(25,992,452)
Cash flows from miscellaneous activities:		
Other cash provided (applied)	<u>42,158,629</u>	<u>(1,131,248)</u>
Net change in cash, cash equivalents, and short-term investments	(8,519,036)	27,320,597
Cash, cash equivalents, and short-term investments, beginning of year	<u>41,745,787</u>	<u>14,425,190</u>
Cash, cash equivalents, and short-term investments, end of year	\$ <u>33,226,751</u>	\$ <u>41,745,787</u>

See accompanying notes.

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Notes to the Statutory Basis Financial Statements

1. Description of Organization

Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) is a non-profit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). KEMI was established by legislation of the Commonwealth enacted April 4, 1994 to serve as a competitive state fund for the purpose of providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage as required by state law. KEMI began writing business effective September 1, 1995.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying statutory basis financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky (the Department), which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). Prescribed statutory accounting policies include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting policies other than those prescribed. The NAIC *Accounting Practices and Procedures Manual* (NAIC SAP) has been adopted as a component of prescribed practices by the Commonwealth of Kentucky. KEMI does not employ any practices not prescribed by the NAIC or the Department of Insurance of the Commonwealth of Kentucky in the preparation of its statutory financial statements. The more significant differences between statutory accounting practices and GAAP are as follows:

- a. Investments in bonds with an NAIC rating of 1 or 2 are carried at NAIC determined value or amortized cost, whereas bonds with a NAIC rating of 3 through 6 are assigned specific year-end values by the NAIC and are written down to Securities Valuation Office (SVO) assigned values (if less than amortized cost) by charging statutory policyholder surplus. Under GAAP, bonds are classified into three categories: held to maturity, available for sale, and trading. Bonds held to maturity are stated at amortized cost; bonds available for sale are stated at fair value and the resulting unrealized gains or losses, net of applicable income taxes, are charged or credited to policyholder surplus; and bonds held for trading are reported at fair value and the resulting unrealized gains and losses are reported in earnings, net of related taxes.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

For loan-backed and structured securities, if the company determines that a security is impaired and they intend to sell the security or no longer have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security shall be written down to fair value. For statutory purposes, if the company subsequently changes their assertion, and now believe they do not intend to sell the security and have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security will continue to be carried at the lower of cost or market with any future decreases in fair value charged through operations until the security is disposed. For GAAP purposes, once the company alters their assertion, that security's amortized cost basis will not be decreased for future reductions in fair value unless an other than temporary impairment is determined to have occurred.

Also, for GAAP purposes, other-than-temporary impairment losses (related to non loan-backed and structured securities) related to debt securities are bifurcated between credit and non-credit, where for statutory purposes the total other-than-temporary impairment loss is reported in earnings.

b. Assets having economic value other than those that can be used to fulfill policyholder obligations are categorized as "nonadmitted assets" and are not permitted to be included in the statutory financial statements of admitted assets, liabilities, and policyholder surplus, whereas, for GAAP, these assets are recognized in the balance sheet. Included with nonadmitted assets are furniture, equipment and supplies, prepaid expenses, certain receivables and other items that do not meet statutory criteria for admitted assets.

c. Receivables over 90 days outstanding are not admitted to the statutory financial statements and charged to policyholder surplus, whereas, for GAAP, the company assesses the collectability of premiums receivable and any charge is to the income statement.

d. The statutory financial statements are presented net of the effects of reinsurance, whereas, for GAAP, the financial statements are presented gross of the effects of reinsurance.

e. Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and, to the extent recoverable, amortized with deferred policy acquisition costs, as required under GAAP.

f. Comprehensive income is not determined for statutory reporting purposes, whereas, for GAAP, such income is recognized.

g. Costs incurred in connection with acquiring new insurance business, including commissions, are charged against statutory earnings as such costs are incurred, while, under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective periods covered by the related policies.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

h. A statutory liability has been established and charged to policyholder surplus for amounts due from unauthorized reinsurers in excess of letters of credit, funds held, and premiums payable. Under GAAP, no such liability is provided.

i. The statutory statement of cash flows differs in certain respects from the presentation required within GAAP literature, including the presentation of changes in cash and short-term investments instead of cash and cash equivalents.

j. The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements that KEMI files with the NAIC and the state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP reporting.

The effect of the differences between statutory accounting practices and accounting principles generally accepted in the United States of America has not been determined, but is presumed to be material.

Risks and Uncertainties

Certain risks and uncertainties are inherent to KEMI's day-to-day operations and to the process of preparing its statutory basis financial statements. The more significant of those risks and uncertainties are presented below and throughout the notes to the statutory basis financial statements.

Use of Estimates - The preparation of the statutory basis financial statements requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statutory basis financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of unpaid losses and loss adjustment expenses. In connection with the determination of this liability, management uses the methodology described in *Unpaid Losses and Loss Adjustment Expenses* later in this footnote. While management uses the best information available to estimate unpaid losses and loss adjustment expenses, future changes to the liability may be necessary based on claims experience and changing claims frequency and severity conditions, as well as changes in doctrines of legal liability and damage awards in Kentucky. The future changes will be charged or credited to expense when they occur.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Loss Reserves - KEMI estimates losses and loss adjustment expenses (LAE) based on the accumulation of case estimates and loss reports, as well as estimates of incurred but not reported (IBNR) losses, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported and unreported claims and incidents. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Actual results could differ from these estimates.

Reinsurance - Reinsurance contracts do not relieve KEMI from its obligations to insureds. Failure of reinsurers to honor their obligations could result in losses to KEMI. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Management believes that any liability arising from this contingency would not be material to KEMI's financial position.

Investment Risk - KEMI is exposed to risks that issuers of securities owned by KEMI will default or that interest rates will change and cause a decrease in the value of its investments. With mortgage-backed securities, KEMI is exposed to credit risk and prepayment risk.

As interest rates decline, the velocity at which these securities pay down the principal will increase. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

KEMI maintains balances at financial institutions that may exceed federally insured limits; however, it also utilizes repurchase agreements and money market funds to mitigate this risk. KEMI's management continually evaluates the financial stability of these financial institutions, and does not believe they are exposed to unnecessary risk.

Since most of KEMI's investments consist of securities that are traded in the public securities markets, they are subject to risk related to fluctuations in overall market performance and are potentially subject to heightened levels of market risk attributable to issuer, industry, and geographic region concentrations. KEMI's investment portfolio is regularly reviewed and the extent of its diversification is considered in the context of statutory requirements and other risk management and performance objectives.

External Factors - KEMI is highly regulated by the state in which it is domiciled. Such regulations, among other things, limit the amount of dividends and impose restrictions on the amount and types of investments. In addition, from time to time, KEMI may be affected by changes in federal regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), or the Patient Protection and Affordable Care Act (PPACA). Additionally, the PPACA contained an amendment with specific language related to black lung claims (the Byrd Amendment). KEMI continues to monitor the impact of such regulations and will assess any potential impact of these changes.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Risk-Based Capital - The NAIC has developed property-casualty risk-based capital (RBC) standards that relate an insurer's reported statutory capital and policyholder surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to protect KEMI from the various risks that it faces. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. KEMI continues to monitor its internal capital requirements and the NAIC's RBC requirements. KEMI has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that KEMI's capital levels are sufficient to support the level of risk inherent in its operations.

Investments

Investments, excluding residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies, are stated at values prescribed by the NAIC's Security Valuation Office (SVO), which generally are as follows:

Non loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method with bonds containing call provisions being amortized to the call or maturity date, whichever results in a lower asset value. Loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method including anticipated prepayments. Bonds rated 3 through 6 are carried at fair value with the change run through policyholder surplus.

Investments in residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies utilize a financial model commissioned by the NAIC to determine credit ratings, and ultimately the NAIC designation/rating. This financial model requires a two step process. KEMI first determines the initial rating designation based upon each security's amortized cost in relation to security specific prescribed break points. This initial rating designation determines whether the security will be stated at amortized cost or fair value, based on the same criteria noted in the preceding paragraph. (The lower the amortized cost relative to par, the higher the NAIC designation, and the more likely the security will be carried at amortized cost.) If the security is to be carried at fair value, KEMI then determines the final rating designation based upon each security's fair value in relation to the same security specific prescribed break points used in the first step. If the security is to be carried at amortized cost, the final designation remains the same as what was determined in the first step. The final designation is used for RBC purposes as well as for NAIC designation disclosure purposes.

Investments in preferred stocks with an NAIC rating designation of 1 or 2 are stated at amortized cost; all other preferred stocks are stated at the lesser of amortized cost or fair value.

Investments in common stocks are stated at fair value with unrealized gains and losses being reported as a separate component of unassigned policyholder surplus.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Investments, continued

Realized gains or losses are determined on the specific-identification method. Investment income is recognized as earned, net of related investment expenses. Bond premiums and discounts are amortized by the scientific-yield method and are charged or credited to net investment income. For mortgage-backed securities, KEMI anticipates prepayments utilizing published data in applying interest income.

The assessment of other-than-temporary impairments is performed on a case-by-case basis. Factors considered by management in determining whether an other-than-temporary impairment exists (in other than loan-backed or structured securities) include: the financial condition, business prospects and creditworthiness of the issuer, the length of time and extent to which fair value has been less than cost for equity securities or amortized cost for fixed income securities, and KEMI's intent and ability to retain such investments until the fair value recovers. If it is determined that the decline in fair market value is other than temporary, the carrying amount of the investment is written down to fair value as its new basis and the amount of the write-down is recorded as a realized loss.

For loan-backed or structured securities, factors considered by management in determining whether an other-than-temporary impairment exists include: KEMI's stated intent to not sell, KEMI's ability to hold such investments until the fair value recovers, and the discounted cash flows of the security based on the yield at the date of acquisition. If KEMI intends to sell or if KEMI does not have the ability and intent to hold the security for a period of time sufficient to recover its amortized cost basis, an other-than-temporary impairment exists, and the security is written down to fair value with the amount of the write-down recorded as a realized loss. If KEMI does not intend to sell the security and has the ability and intent to hold the security for a period of time sufficient to recover the amortized cost basis, KEMI calculates the cash flows expected to be collected. In this calculation, KEMI compares the present value of cash flows expected to be collected, discounted at the security's effective interest rate at date of purchase, to the amortized cost basis. If the present value of cash flows is less than the amortized cost basis, a realized loss is recorded for the difference. The present value of cash flows then becomes the new cost basis.

KEMI uses the prospective method to accrete the amortized cost basis to the ultimate expected cash flows.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Securities Lending Transactions

During 2014, KEMI began investing in securities lending transactions. Securities lending involves a transfer of securities (such as shares or bonds) to a third party (the borrower), who will give the lender collateral in the form of shares, bonds or cash. The borrowers of the securities agree to transfer to KEMI's custodial bank either cash collateral or other securities with an initial fair value of 102% of the value of the borrowed securities. The borrowers of the securities simultaneously agree to return the borrowed securities in exchange for the collateral at a later date. If at any time the fair value of the collateral falls below 100% of the fair value of domestic securities loaned, the counterparty is obligated to deliver additional collateral to restore the initial 102% collateral requirement. KEMI primarily receives cash collateral under these securities lending transactions which is reinvested in readily liquid and marketable short-term investments and is included as an asset under "Securities lending collateral reinvested." The offsetting collateral liability is included in "Payable for securities lending."

The borrowers pay KEMI a fee each month for the loans and are contractually obligated to return the securities on demand. The borrowers also pass over to KEMI any dividends/interest payments that may arise. Deutsche Bank is the agent in these transactions and invests cash collateral as permitted by state statutes and KEMI policy. Deutsche Bank cannot pledge or sell collateral securities received unless the borrower defaults.

The credit quality of the securities lending portfolio at December 31, 2014 is presented as follows:

	<u>Carrying Value</u>	<u>Percentage</u>
Class 1 - highest quality	\$ 27,000,000	98.1 %
Unrated	<u>519,835</u>	<u>1.9</u>
Total	\$ <u>27,519,835</u>	<u>100 %</u>

Premiums

Premiums are earned on the daily pro-rata method over the policy period and are stated after deduction for reinsurance. Unearned premiums represent the portion of initial premiums written that are applicable to the unexpired terms of policies in force. Initial premiums are recorded as premiums written on the policy effective date except for certain premiums that are recorded on an installment basis. Any subsequent additional premiums or refunds that occur as a result of policy audits are recorded as written premiums at the time the policy audits are finalized. Earned but unbilled premiums represent management's estimate of future audit premiums and are included in premiums booked but deferred and not yet due.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Premiums, continued

Premiums in course of collection which are customer obligations due under normal terms requiring payment by the policy due date, and premiums booked but deferred and not yet due are valued at their carrying amount, which approximates fair value. Receivables over 90 days outstanding are not admitted to the statutory basis financial statements.

Unpaid Losses and Loss Adjustment Expenses

The estimated liability for losses is based on the accumulation of case estimates for claims and incidents reported, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported claims and incidents. Also included in the liability are estimates of incurred but not reported losses based on historical experience adjusted for current trends. The reserves for unpaid losses are net of anticipated subrogation. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Estimates for loss and related LAE are made without regard to the time value of money.

Management believes that the provisions for losses and LAE are adequate to cover the net cost of claims incurred and incidents reported; however, the provisions are necessarily based upon estimates and, therefore, the ultimate liability may be less than or exceed such estimates. As adjustments become necessary in these estimates, such adjustments are reflected in the results of operations in the period in which they are determined.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums, losses, and loss adjustment expenses are reported net of reinsured amounts. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. KEMI holds collateral as security under reinsurance agreements in the form of letters of credit for any reinsurers not subject to the regulation of the Kentucky Commissioner of Insurance. In the opinion of management, all amounts due from reinsurers at December 31, 2014 and 2013 are recoverable.

Cash, Cash Equivalents, and Short-Term Investments

Cash, cash equivalents, and short-term investments consist of cash on deposit with financial institutions and investments with original maturities of: cash equivalents - less than three months, short-term investments - less than one year. These investments are carried at cost, which approximates fair value.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Concentrations of Geographic and Credit Risk

All of KEMI's total direct gross written premiums of \$158,146,286 for the year ended December 31, 2014 were for insureds in Kentucky.

The credit quality of the long-term bond portfolio at December 31, 2014 is presented as follows:

	<u>Carrying Value</u>	<u>Percentage</u>
Class 1 - highest quality	\$ 630,741,300	87.4 %
Class 2 - high quality	<u>91,176,736</u>	<u>12.6</u>
Total	<u>\$ 721,918,036</u>	<u>100 %</u>

Bonds with ratings from AAA to BBB as assigned by Standard & Poor's Corporation are generally considered as investment grade securities. Some securities issued by the U.S. government or an agency thereof are not rated but are considered to be investment grade. The NAIC regards U.S. Treasuries and agencies and all A ratings as Class 1 (highest quality), BBB ratings as Class 2 (high quality), BB ratings as Class 3 (medium quality), B ratings as Class 4 (low quality), C ratings as Class 5 (lower quality), and D ratings as Class 6 (in or near default).

Property and Equipment

Electronic data processing equipment, including operating software, is stated at cost less accumulated depreciation. Depreciation expense on such property was \$210,064 and \$218,886 in 2014 and 2013, respectively. Furniture, office equipment, and application software are non-admitted assets under statutory accounting practices. Depreciation expense on such property was \$159,365 and \$154,983 in 2014 and 2013, respectively.

Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. Gains and losses on the sale of property and equipment are recorded in the year of disposition. Maintenance and repairs are expensed as incurred; replacements and betterments are capitalized.

Advertising

KEMI expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2014 and 2013, was \$819,400 and \$1,319,518, respectively.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Subsequent Events

All of the effects of subsequent events that provide additional evidence about conditions that existed at the statement of admitted assets, liabilities and policyholder surplus date, including the estimates inherent in the process of preparing the statutory basis financial statements, are recognized in the statutory basis financial statements. KEMI does not recognize subsequent events that provide evidence about conditions that did not exist at the statement of admitted assets, liabilities and policyholder surplus date but arose after, but before the statutory basis financial statements are available to be issued. In some cases, nonrecognized subsequent events are disclosed to keep the statutory basis financial statements from being misleading.

Management has evaluated subsequent events for accounting and disclosure requirements through March 30, 2015, the date that the statutory basis financial statements were available to be issued. There were no events occurring during the evaluation period that require recognition or disclosure in the statutory basis financial statements.

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Notes to the Statutory Basis Financial Statements, continued

3. Investments

Long-Term Bonds

The statement value, gross unrealized gains, gross unrealized losses, and the estimated fair value of investments in long-term bonds are summarized as follows:

	Statement Value	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
As of December 31, 2014:				
U.S. government securities	\$ 46,745,074	\$ 554,898	\$ (370,392)	\$ 46,929,580
U.S. agency mortgage-backed securities	2,524,716	82,328	-	2,607,044
U.S. special revenue bonds	196,249,390	7,291,089	(389,666)	203,150,813
Commercial mortgage-backed securities	52,265,658	1,136,071	(200,839)	53,200,890
Commercial asset-backed securities	58,922,403	410,692	(102,569)	59,230,526
Other corporate bonds	356,880,600	15,510,709	(2,071,597)	370,319,712
All other bonds	<u>8,330,195</u>	<u>429,405</u>	<u>(11,285)</u>	<u>8,748,315</u>
	<u>\$ 721,918,036</u>	<u>\$ 25,415,192</u>	<u>\$ (3,146,348)</u>	<u>\$ 744,186,880</u>
As of December 31, 2013:				
U.S. government securities	\$ 51,923,528	\$ 214,018	\$ (3,267,780)	\$ 48,869,766
U.S. agency mortgage-backed securities	3,190,387	95,010	-	3,285,397
U.S. special revenue bonds	163,784,396	4,735,914	(2,879,686)	165,640,624
Commercial mortgage-backed securities	45,334,942	1,057,774	(787,319)	45,605,397
Commercial asset-backed securities	42,270,807	591,260	(86,487)	42,775,580
Other corporate bonds	351,785,590	15,144,818	(6,577,287)	360,353,121
All other bonds	<u>8,304,833</u>	<u>183,639</u>	<u>(81,025)</u>	<u>8,407,447</u>
	<u>\$ 666,594,483</u>	<u>\$ 22,022,433</u>	<u>\$ (13,679,584)</u>	<u>\$ 674,937,332</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Long-Term Bonds, continued

The carrying value and estimated fair value of long-term bonds at December 31, 2014, by contractual maturity, are as follows. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Statement Value	Estimated Fair Value
Less than one year	\$ 22,331,273	\$ 22,493,075
One year through five years	233,885,731	242,444,740
Six years through ten years	211,184,497	216,456,119
After ten years	<u>254,516,535</u>	<u>262,792,946</u>
	\$ <u>721,918,036</u>	\$ <u>744,186,880</u>

Proceeds from sales of bonds during 2014 and 2013 were \$83,526,857 and \$77,111,348, respectively. Gross gains of \$3,352,464 and \$1,708,379, and gross losses of \$621,479 and \$588,114 were realized on those sales in 2014 and 2013, respectively.

Common Stock

Gross unrealized capital gains and losses on common stock are included in policyholder surplus as follows:

	<u>2014</u>	<u>2013</u>
Cost	\$ 62,862,230	\$ 49,132,911
Gross unrealized capital gains	12,937,841	12,454,102
Gross unrealized capital losses	<u>(1,128,677)</u>	<u>(419,824)</u>
Net unrealized capital gain	<u>11,809,164</u>	<u>12,034,278</u>
Fair value	\$ <u>74,671,394</u>	\$ <u>61,167,189</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment

The following table illustrates the gross unrealized losses and fair value of investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment type and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2014 and 2013:

	December 31, 2014					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. government	\$ -	\$ -	\$ 12,446,435	\$ (370,392)	\$ 12,446,435	\$ (370,392)
U.S. special revenue	15,015,869	(45,320)	21,220,976	(344,346)	36,236,845	(389,666)
Commercial mortgage-backed	12,235,671	(73,059)	4,884,246	(127,780)	17,119,917	(200,839)
Commercial asset-backed	31,315,831	(102,569)	-	-	31,315,831	(102,569)
Other corporate bonds	53,672,843	(945,962)	35,127,970	(1,125,635)	88,800,813	(2,071,597)
All other bonds	2,020,480	(11,285)	-	-	2,020,480	(11,285)
Common stock	<u>8,579,689</u>	<u>(1,026,119)</u>	<u>256,880</u>	<u>(102,558)</u>	<u>8,836,569</u>	<u>(1,128,677)</u>
Total	<u>\$ 122,840,383</u>	<u>\$ (2,204,314)</u>	<u>\$ 73,936,507</u>	<u>\$ (2,070,711)</u>	<u>\$ 196,776,890</u>	<u>\$ (4,275,025)</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

	December 31, 2013					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. government	\$ 37,862,891	\$ (2,976,583)	\$ 2,707,969	\$ (291,197)	\$ 40,570,860	\$ (3,267,780)
U.S. special revenue	71,875,549	(2,780,685)	2,155,793	(99,001)	74,031,342	(2,879,686)
Commercial mortgage- backed	15,891,341	(681,585)	1,127,156	(105,734)	17,018,497	(787,319)
Commercial asset-backed	14,061,731	(86,487)	-	-	14,061,731	(86,487)
Other corporate bonds	113,755,511	(5,994,188)	6,814,247	(583,099)	120,569,758	(6,577,287)
All other bonds	2,236,846	(81,025)	-	-	2,236,846	(81,025)
Common stock	5,164,815	(419,824)	-	-	5,164,815	(419,824)
Total	\$ 260,848,684	\$ (13,020,377)	\$ 12,805,165	\$ (1,079,031)	\$ 273,653,849	\$ (14,099,408)

KEMI evaluates impairment at each reporting period for each of the securities whereby the fair value of the investment is less than its amortized cost. It is expected that the securities would not be settled at a price less than the amortized cost of the investment, as KEMI has the ability and intent to hold the investment until there is not an unrealized loss on the investment. For valuing loan-backed and structured securities, KEMI's asset manager uses a proprietary model for loss assumptions and widely accepted models for prepayment assumptions with inputs from major third party data providers. Model assumptions are specific to asset class and collateral types and are regularly evaluated and adjusted where appropriate.

KEMI evaluated the credit ratings of these holdings, noting neither a significant deterioration since purchase nor other factors which may indicate an other-than-temporary impairment, such as the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and KEMI's intent and ability to hold the investment for a sufficient time in order to enable recovery of cost.

KEMI continues to review its investment portfolio under its impairment review policy. Given the fluctuating market conditions and the significant judgment involved, there is a continuing risk that further declines in fair value may occur and additional other-than-temporary impairments may be recorded in future periods.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements

The following table presents the carrying value and estimated fair value of KEMI's significant financial instruments that are not carried at estimated fair value at December 31, 2014 and 2013:

	<u>2014</u>		<u>2013</u>	
	<u>Statement</u> <u>Value</u>	<u>Estimated</u> <u>Fair Value</u>	<u>Statement</u> <u>Value</u>	<u>Estimated</u> <u>Fair Value</u>
Cash, cash equivalents, and short-term investments	\$ 33,226,751	\$ 33,226,751	\$ 41,745,787	\$ 41,745,787
U.S. government securities	46,745,074	46,929,580	51,923,528	48,869,766
U.S. agency mortgage-backed securities	2,524,716	2,607,044	3,190,387	3,285,397
U.S. special revenue bonds	196,249,390	203,150,813	163,784,396	165,640,624
Commercial mortgage-backed securities	52,265,658	53,200,890	45,334,942	45,605,397
Commercial asset-backed securities	58,922,403	59,230,526	42,270,807	42,775,580
Other corporate bonds	356,880,600	370,319,712	351,785,590	360,353,121
All other bonds	<u>8,330,195</u>	<u>8,748,315</u>	<u>8,304,833</u>	<u>8,407,447</u>
Total	\$ <u>755,144,787</u>	\$ <u>777,413,631</u>	\$ <u>708,340,270</u>	\$ <u>716,683,119</u>

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2014 and 2013. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these statutory financial statements since that date, and current estimates of fair value may differ significantly from the amounts presented herein.

The following methods and assumptions were used to estimate the fair value of each significant class of financial instruments for which it is practical to estimate that value:

Cash, cash equivalents, and short-term investments: Valued at cost. The carrying amounts reported in the statements of admitted assets, liabilities and policyholder surplus approximate their fair value due to their short maturity.

Bonds, loan-backed and structured securities, and common stock: Valued at fair value by reference to identical trades in active markets and by a third party portfolio manager. Fair values are based on values published by the SVO, quoted market prices, or dealer quotes. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services, or in the case of private placements, are estimated by discounting the expected future cash flows using current market rates applicable to the yield, credit, and maturity of the investment.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

KEMI's financial assets carried at fair value have been classified, for disclosure purposes, based on a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to fair values determined using unadjusted quoted prices in active markets for identical assets (Level 1) and the lowest priority to fair values determined using unobservable inputs (Level 3). An asset's classification is determined based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets that KEMI has the ability to access at the measurement date.

Level 2 – Valuations derived from inputs other than quoted market prices included within Level 1 that are observable for the asset, either directly or indirectly, such as:

- a) Quoted prices for similar assets in active markets.
- b) Quoted prices for identical or similar assets in markets that are not active.
- c) Inputs other than quoted prices that are observable for the asset.
- d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Valuations are derived from techniques that require significant unobservable inputs. The unobservable inputs reflect KEMI's own assumptions about the assumptions that market participants would use in pricing the asset.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

KEMI holds common stocks and other securities that are measured at fair value on a recurring basis. In addition, KEMI sometimes holds certain financial assets, primarily certain bonds valued at the lower of cost or fair value in accordance with NAIC reporting guidelines and assets that are impaired during the current reporting period and carried at fair value, that are considered to be measured at fair value on a recurring basis. The following table summarizes KEMI's assets measured at fair value on a recurring basis. Management has elected not to further disaggregate the investments displayed below as additional risk information is not deemed material to the financial statements.

	<u>Fair Value</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2014				
Investments:				
Common stock	\$ 74,671,394	\$ 74,671,394	\$ -	\$ -
Securities lending collateral reinvested:				
Repurchase agreements	<u>27,519,835</u>	<u>27,519,835</u>	<u>-</u>	<u>-</u>
Total assets at fair value	<u>\$ 102,191,229</u>	<u>\$ 102,191,229</u>	<u>\$ -</u>	<u>\$ -</u>

	<u>Fair Value</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2013				
Investments:				
Common stock	<u>\$ 61,167,189</u>	<u>\$ 61,167,189</u>	<u>\$ -</u>	<u>\$ -</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

5. Losses and Loss Adjustment Expenses

As of December 31, 2014 and 2013, the following table provides a reconciliation of the beginning and ending reserve balances for losses and loss adjustment expenses (LAE):

	<u>2014</u>	<u>2013</u>
Gross reserves for losses and LAE - beginning of year	\$ 564,461,939	\$ 549,645,904
Less reinsurance recoverables	<u>33,200,124</u>	<u>51,988,383</u>
Net reserves for losses and LAE - beginning of year	531,261,815	497,657,521
Provision for claims, related to:		
Current year	138,080,995	117,170,280
Prior years	<u>(3,791,341)</u>	<u>(9,460,942)</u>
Total incurred	134,289,654	107,709,338
Payments for claims, related to:		
Current year	(42,360,905)	(35,253,983)
Prior years	<u>(60,887,529)</u>	<u>(38,851,061)</u>
Total paid	<u>(103,248,434)</u>	<u>(74,105,044)</u>
Net reserves for losses and LAE - end of year	562,303,035	531,261,815
Plus reinsurance recoverables	<u>33,345,764</u>	<u>33,200,124</u>
Gross reserves for losses and LAE - end of year	\$ <u>595,648,799</u>	\$ <u>564,461,939</u>

As a result of changes in estimates of insured events in prior years, the liability for unpaid losses and loss adjustment expenses (net of reinsurance recoverables) decreased by \$3,791,341 and \$9,460,942 in 2014 and 2013, respectively. Payments for claims related to prior years are net of \$300,000 and \$16,844,330 for reinsurance commutation funds received in 2014 and 2013, respectively. Estimated subrogation recoverable on unpaid losses was \$3,500,000 as of December 31, 2014 and 2013.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance

KEMI limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with various reinsurers under excess of loss agreements. These agreements cede premium on an earned basis. Ceded reinsurance is treated as the risk and liability of the assuming companies; however, these reinsurance contracts do not relieve KEMI from its original obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to KEMI; consequently, allowances are established for amounts deemed uncollectible, if any. KEMI evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

KEMI maintains Excess of Loss reinsurance coverage (including terrorism) with unaffiliated reinsurers for losses and loss adjustment expenses in excess of \$3.0 million per occurrence and up to \$125 million per occurrence. The Excess of Loss reinsurance agreements apply to KEMI's net retained liability, covering direct and assumed business in force as of each effective date, as well as business new or renewed from the effective date through the end of the contract term. Unpaid losses and loss adjustment expenses as of December 31, 2014 and 2013 included estimated reinsurance recoverables under the Excess of Loss agreements of \$33,345,764 and \$33,200,124, respectively.

KEMI commuted certain Excess of Loss reinsurance treaties with unaffiliated reinsurers during both 2014 and 2013. KEMI recognized the amounts received from the reinsurers as a reduction of losses and loss adjustment expenses paid in the current year (thereby reducing net losses and loss adjustment expenses incurred). KEMI also increased its net reserves for losses and loss adjustment expenses (thereby increasing losses and loss adjustment expenses incurred) to recognize the effects of releasing the reinsurers from their obligations under the treaties. The net effect of these commutations was a (decrease) increase in losses and loss adjustment expenses incurred of (\$44,168) and \$1,744,194 in 2014 and 2013, respectively.

Effective April 1, 2011, KEMI engaged in an assumptive reinsurance arrangement with Zurich American Insurance Company (Zurich) through which KEMI offers multi-state coverage to its policyholders. Under the agreement, Zurich writes certain policies for which KEMI assumes 100% of the business. This coverage is only available to Kentucky-based businesses that have similar operations in other states. KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2014 and 2013 includes \$1,556,432 and \$1,347,097, respectively, related to this agreement. Zurich requires KEMI to maintain a standby letter of credit in the amount of \$11,000,000. The letter of credit is collateralized by U.S. Treasury Bonds.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

Effective January 1, 2007 through March 31, 2011, KEMI engaged in an assumptive reinsurance arrangement with Argonaut Insurance Company (Argonaut) through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Argonaut wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective March 31, 2011, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2014 and 2013 includes \$50,000 and \$552,269, respectively, related to this agreement. Argonaut requires KEMI to maintain a standby letter of credit in the amount of \$900,000. The letter of credit is collateralized by U.S. Treasury Bonds.

Effective January 1, 2001 through December 31, 2002, KEMI engaged in an assumptive reinsurance arrangement with Fireman's Fund Insurance Company (Fireman's Fund) through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Fireman's Fund wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective December 31, 2002, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2014 and 2013 includes \$707,151 and \$718,895, respectively, related to this agreement. Fireman's Fund requires KEMI to maintain a standby letter of credit in the amount of \$1,250,000. The letter of credit is collateralized by U.S. Treasury Bonds.

KEMI reported a provision for reinsurance in the amount of \$43,250 and \$172,550 at December 31, 2014 and 2013, respectively. This provision represents net recoverables from unauthorized (foreign) reinsurers for losses, loss adjustment expenses, and unearned premiums in excess of reinsurer deposits and letters of credit. When applicable, the provision for reinsurance also includes 20% of reinsurance receivables greater than 90 days past due or in dispute. None of KEMI's reinsurance receivables were overdue or in dispute at December 31, 2014 or 2013.

KEMI had no unsecured net reinsurance recoverables outstanding for losses and loss adjustment expenses, paid and unpaid, including IBNR and unearned premium that individually exceeded 3% of policyholder surplus at December 31, 2014 or 2013.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

A summary of reinsurance transactions for 2014 and 2013 is as follows:

	<u>2014</u>	<u>2013</u>
Written premiums:		
Direct	\$ 158,146,286	\$ 143,753,266
Assumed	5,339,623	5,139,759
Ceded	<u>(5,744,052)</u>	<u>(6,069,542)</u>
Net	<u>\$ 157,741,857</u>	<u>\$ 142,823,483</u>
Earned premiums:		
Direct	\$ 153,283,660	\$ 134,528,324
Assumed	5,181,993	4,681,713
Ceded	<u>(5,744,052)</u>	<u>(6,069,542)</u>
Net	<u>\$ 152,721,601</u>	<u>\$ 133,140,495</u>
Incurred losses and LAE:		
Direct	\$ 131,409,224	\$ 102,553,038
Assumed	3,590,581	3,543,865
Ceded	<u>(710,151)</u>	<u>1,612,435</u>
Net	<u>\$ 134,289,654</u>	<u>\$ 107,709,338</u>
Unearned premiums:		
Direct	\$ 72,352,200	\$ 67,214,805
Assumed	1,967,755	1,810,125
Ceded	<u>-</u>	<u>-</u>
Net	74,319,955	69,024,930
Adjustment for earned but unbilled premiums	<u>(3,095,433)</u>	<u>(2,820,664)</u>
Net	<u>\$ 71,224,522</u>	<u>\$ 66,204,266</u>

KEMI has evaluated its reinsurance arrangements and believe they appropriately transfer risk in accordance with SSAP No. 62, *Property and Casualty Reinsurance*, and have therefore accounted for them as prospective reinsurance.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

7. Loss Portfolio Transfer

During 2014, KEMI voluntarily executed a loss portfolio transfer with the Commissioner of the Kentucky Department of Insurance in her role as Rehabilitator of the Kentucky School Boards Insurance Trust Workers' Compensation Self Insurance Fund (KSBIT-WC). In exchange for \$35 million of assessments due from the school boards formerly insured by KSBIT-WC, KEMI assumed responsibility for the handling of approximately \$35 million in unpaid claim liabilities. The individual school boards were given the option of paying their entire assessment as a lump sum, or paying 25% in cash and financing the remainder in interest free installments over a period not to exceed six years. Under the terms of the agreements signed by the individual school boards, in the event of nonpayment, the Kentucky Department of Education will be instructed to withhold the unpaid portion of the assessments from appropriations otherwise due to the school boards from the Commonwealth of Kentucky. As of December 31, 2014, the liability for KSBIT-WC unpaid claims was \$33,393,484 and the balance of the receivable for retroactive reinsurance reserve assumed was \$18,703,897.

8. Leases

KEMI leases space for its main office under a noncancellable operating lease which expires December 31, 2020. KEMI has two options to extend the lease, each for an additional 60 months following its expiration. Rental expense under this lease was \$1,006,142 and \$1,013,912 for 2014 and 2013, respectively. KEMI also leases space for a satellite office under a noncancellable operating lease which expires May 31, 2017. Rental expense under this lease was \$119,403 and \$120,497 for 2014 and 2013, respectively. The following is a summary of future minimum rental commitments for these leases:

2015	\$ 1,119,133
2016	1,121,328
2017	1,049,928
2018	998,928
2019	998,928
Thereafter	<u>998,928</u>
	<u>\$ 6,287,173</u>

9. Policyholder Dividend

During 2014, KEMI's Board of Directors approved a policyholder dividend in the amount of \$3,420,959. To be eligible, policyholders must have had a KEMI policy with a 2011 effective date and a total loss ratio of 75% or less. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

9. Policyholder Dividend, continued

During 2013, KEMI's Board of Directors approved a policyholder dividend in the amount of \$6,428,792. To be eligible, policyholders must have had a KEMI policy with a 2010 effective date and a total loss ratio of 75% or less. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status.

10. Retirement Plans

Eligible KEMI employees participate in the Kentucky Employees Retirement System (KERS). KERS is a contributory defined benefit pension plan sponsored by Kentucky Retirement Systems, in which KEMI is a member. Employees hired prior to September 1, 2008 are required to contribute 5% of gross salary to KERS, while those hired on or after September 1, 2008 are required to contribute 6% of gross salary. Employers contribute at a rate determined by the Board of Kentucky Retirement Systems to maintain the financial soundness of KERS. The employer contribution rate, which may be adjusted annually based on the actuarial valuation of KERS, was 38.77% and 26.79% at December 31, 2014 and 2013, respectively. Total pension expense paid by KEMI during 2014 and 2013 was \$4,961,109 and \$3,536,570, respectively. As of June 30, 2014, the most recent actuarial valuation date, KERS's total actuarial liability was \$12,366,960,287 and the actuarial value of assets totaled \$2,951,853,977. The portion of this obligation and the related assets attributable to KEMI's employees is relatively insignificant in relation to the plan's totals.

Eligible KEMI employees may also participate in the Kentucky Deferred Compensation Plan, a defined contribution plan for which KEMI matches up to 50% of the first 6% of compensation deferred by employees. Total contributions made by KEMI were \$280,106 and \$269,448 in 2014 and 2013, respectively.

11. Federal Income Taxes

As described in Note 1, KEMI is a political subdivision of the Commonwealth and was created by legislation to serve as the insurer of last resort as well as a competitive force to stabilize the workers' compensation market in Kentucky. The Commonwealth provided KEMI's initial funding and continues to influence KEMI through Governor appointed board members and through the role of oversight. For these reasons, KEMI's management believes KEMI is a tax-exempt entity pursuant to Internal Revenue Code sections §115 and §501(c)(27) and therefore not subject to federal income taxes. Accordingly, the statutory basis financial statements do not include a provision for federal income taxes.

12. Contingencies

KEMI is involved in litigation and may become involved in potential litigation arising in the ordinary course of business. Additionally, KEMI may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope of originally contemplated policies. In the opinion of management, the effects, if any, of such litigation and published court decisions are not expected to be material to the statutory basis financial statements.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

13. Statutory Requirements

Under the insurance regulations of the Commonwealth of Kentucky, the amount of dividends that KEMI may pay to its policyholders is limited to the excess of actuarially determined minimum policyholder surplus requirements. Actuarially determined minimum policyholder surplus takes into consideration the company's present liabilities as well as management's expectation of future business volumes, claims activity and investment performance. The Commonwealth of Kentucky's statutory minimum policyholder surplus requirement is \$1,500,000.



Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Report of Independent Auditors

Board of Directors

Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the statutory basis financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI), as of and for the year ended December 31, 2014, and the related notes to the statutory basis financial statements, which collectively comprise KEMI's basic statutory financial statements, and have issued our report thereon dated March 30, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the statutory basis financial statements, we considered KEMI's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of KEMI's internal control. Accordingly, we do not express an opinion on the effectiveness of KEMI's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page 2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KEMI's statutory basis financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of statutory basis financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Dean Dotson Allen Ford, PLLC

March 30, 2015
Lexington, Kentucky



Awareness Letter

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We were engaged by Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) to perform annual audits, in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, of KEMI's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of the Commonwealth of Kentucky and the related rules and regulations of the Department of Insurance of the Commonwealth of Kentucky that are applicable to audits of statutory financial statements of insurance entities. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of KEMI as to their conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky.

This letter is intended solely for the information and use of the board of directors and management of KEMI and the Department of Insurance of the Commonwealth of Kentucky and is not intended to be, and should not be, used for anyone other than these specified parties.

Dean Dorton Allen Ford, PLLC

March 30, 2015
Lexington, Kentucky



Qualification Letter

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

To the Board of Directors of Kentucky Employers' Mutual Insurance:

We have audited, in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the statutory financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) for the years ended December 31, 2014 and 2013, and have issued our report thereon dated March 30, 2015. In connection therewith, we advise you as follows:

- a) We are independent certified public accountants with respect to KEMI and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the Kentucky State Board of Accountancy.
- b) The engagement partner, who is a certified public accountant, and the engagement manager have over 27 years and 7 years, respectively, of experience in public accounting. The engagement partner is very experienced in auditing insurance entities. The engagement manager is new to the industry but has been to a week-long insurance training. Members of the engagement team, most of whom have had experience in auditing insurance entities and 60% of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c) We understand that KEMI intends to file its audited statutory financial statements and our report thereon with the Department of Insurance of the Commonwealth of Kentucky (the Department) and that the commissioner of the Department will be relying on that information in monitoring and regulating the statutory financial condition of KEMI.

Although we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, KEMI and the Department should understand that the objective of an audit of statutory basis financial statements in accordance with auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards*, is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, policyholder surplus, as well as results of operations and cash flows in conformity with accounting practices prescribed or permitted by the Department. Consequently, under auditing standards generally accepted in the United States of America, and the standards applicable to financial audits contained in *Government Auditing Standards*, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on statutory financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of KEMI to adopt sound accounting policies, to maintain an adequate and effective system of accounts and to establish and maintain an internal control that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of statutory basis financial statements in conformity with accounting practices prescribed or permitted by the Department.

The Department should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the report of independent auditors.

- d) We will retain the workpapers prepared in the conduct of our audit until the Department has filed a Report of Examination covering 2014, but no longer than seven years. After notification to KEMI, we will make the workpapers available for review by the Department at the offices of the insurer, at our office, at the Department or at any other reasonable place designated by the Department. Furthermore, in the conduct of the aforementioned periodic review by the Department, photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Department.
- e) The engagement partner has served in that capacity with respect to KEMI since 2013, is licensed by the Kentucky State Board of Accountancy and is a member in good standing of the American Institute of Certified Public Accountants.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

- f) To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC *Annual Financial Reporting Model Regulation Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.

Dean Dorton Allen Ford, PLLC

March 30, 2015
Lexington, Kentucky

SUPPLEMENTARY INFORMATION

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement			
	1 Amount	2 Percentage	3 Amount	4 Securities Lending Reinvested Collateral Amount	5 Total (Col. 3 + 4) Amount	6 Percentage
1. Bonds:						
1.1 U.S. treasury securities	46,745,074	5.4	46,745,074		46,745,074	5.4
1.2 U.S. government agency obligations (excluding mortgage-backed securities):						
1.21 Issued by U.S. government agencies		0.0			0	0.0
1.22 Issued by U.S. government sponsored agencies	21,372,038	2.5	21,372,038		21,372,038	2.5
1.3 Non-U.S. government (including Canada, excluding mortgage-backed securities)	6,020,176	0.7	6,020,176		6,020,176	0.7
1.4 Securities issued by states, territories and possessions and political subdivisions in the U.S.:						
1.41 States, territories and possessions general obligations	1,164,957	0.1	1,164,957		1,164,957	0.1
1.42 Political subdivisions of states, territories and possessions and political subdivisions general obligations	1,145,062	0.1	1,145,062		1,145,062	0.1
1.43 Revenue and assessment obligations	12,601,729	1.5	12,601,729		12,601,729	1.5
1.44 Industrial development and similar obligations		0.0			0	0.0
1.5 Mortgage-backed securities (includes residential and commercial MBS):						
1.51 Pass-through securities:						
1.511 Issued or guaranteed by GNMA	619,311	0.1	619,311		619,311	0.1
1.512 Issued or guaranteed by FNMA and FHLMC	141,426,935	16.4	141,426,935		141,426,935	16.4
1.513 All other		0.0			0	0.0
1.52 CMOs and REMICs:						
1.521 Issued or guaranteed by GNMA, FNMA, FHLMC or VA	22,469,210	2.6	22,469,210		22,469,210	2.6
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-based securities issued or guaranteed by agencies shown in Line 1.521		0.0			0	0.0
1.523 All other	52,265,658	6.1	52,265,658		52,265,658	6.1
2. Other debt and other fixed income securities (excluding short-term):						
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	318,589,770	37.0	318,589,770		318,589,770	37.0
2.2 Unaffiliated non-U.S. securities (including Canada)	97,498,116	11.3	97,498,116		97,498,116	11.3
2.3 Affiliated securities		0.0			0	0.0
3. Equity interests:						
3.1 Investments in mutual funds		0.0			0	0.0
3.2 Preferred stocks:						
3.21 Affiliated		0.0			0	0.0
3.22 Unaffiliated		0.0			0	0.0
3.3 Publicly traded equity securities (excluding preferred stocks):						
3.31 Affiliated		0.0			0	0.0
3.32 Unaffiliated	74,671,394	8.7	74,671,394		74,671,394	8.7
3.4 Other equity securities:						
3.41 Affiliated		0.0			0	0.0
3.42 Unaffiliated		0.0			0	0.0
3.5 Other equity interests including tangible personal property under lease						
3.51 Affiliated		0.0			0	0.0
3.52 Unaffiliated		0.0			0	0.0
4. Mortgage loans:						
4.1 Construction and land development		0.0			0	0.0
4.2 Agricultural		0.0			0	0.0
4.3 Single family residential properties		0.0			0	0.0
4.4 Multifamily residential properties		0.0			0	0.0
4.5 Commercial loans		0.0			0	0.0
4.6 Mezzanine real estate loans		0.0			0	0.0
5. Real estate investments:						
5.1 Property occupied by company		0.0			0	0.0
5.2 Property held for production of income (including \$_____ of property acquired in satisfaction of debt)		0.0			0	0.0
5.3 Property held for sale (including \$_____ of property acquired in satisfaction of debt)		0.0			0	0.0
6. Contract loans		0.0			0	0.0
7. Derivatives		0.0			0	0.0
8. Receivables for securities	3,511,596	0.4	3,511,596		3,511,596	0.4
9. Securities lending (Line 10, Asset Page reinvested collateral)	27,519,835	3.2	27,519,835	XXX	XXX	XXX
10. Cash, cash equivalents and short-term investments	33,226,751	3.9	33,226,751	27,519,835	60,746,586	7.1
11. Other invested assets		0.0			0	0.0
12. Total invested assets	860,847,612	100.0	860,847,612	27,519,835	860,847,612	100.0

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement			
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1.43 Revenue and assessment obligations	12,601,729	1.5	12,601,729		12,601,729	1.5
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1.5 Mortgage-backed securities (includes residential and commercial MBS):						
1.51 Pass-through securities:						
1.511 Issued or guaranteed by GNMA	619,311	0.1	619,311		619,311	0.1
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1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-based securities issued or guaranteed by agencies shown in Line 1.521		0.0			0	0.0
1.523 All other	52,265,658	6.1	52,265,658		52,265,658	6.1
2. Other debt and other fixed income securities (excluding short-term):						
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities)	318,589,770	37.0	318,589,770		318,589,770	37.0
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3.2 Preferred stocks:						
3.21 Affiliated		0.0			0	0.0
3.22 Unaffiliated		0.0			0	0.0
3.3 Publicly traded equity securities (excluding preferred stocks):						
3.31 Affiliated		0.0			0	0.0
3.32 Unaffiliated	74,671,394	8.7	74,671,394		74,671,394	8.7
3.4 Other equity securities:						
3.41 Affiliated		0.0			0	0.0
3.42 Unaffiliated		0.0			0	0.0
3.5 Other equity interests including tangible personal property under lease:						
3.51 Affiliated		0.0			0	0.0
3.52 Unaffiliated		0.0			0	0.0
4. Mortgage loans:						
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4.2 Agricultural		0.0			0	0.0
4.3 Single family residential properties		0.0			0	0.0
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4.5 Commercial loans		0.0			0	0.0
4.6 Mezzanine real estate loans		0.0			0	0.0
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5.3 Property held for sale (including \$ _____ of property acquired in satisfaction of debt)		0.0			0	0.0
6. Contract loans		0.0			0	0.0
7. Derivatives		0.0			0	0.0
8. Receivables for securities	3,511,596	0.4	3,511,596		3,511,596	0.4
9. Securities lending (Line 10, Asset Page reinvested collateral)	27,519,835	3.2	27,519,835	XXX	XXX	XXX
10. Cash, cash equivalents and short-term investments	33,226,751	3.9	33,226,751	27,519,835	60,746,586	7.1
11. Other invested assets		0.0			0	0.0
12. Total invested assets	860,847,612	100.0	860,847,612	27,519,835	860,847,612	100.0



SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES

For the year ended December 31, 2014

(To be filed by April 1)

OF KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

Address (City, State, Zip Code): Lexington KY 40507-1724

NAIC Group Code.....0

NAIC Company Code.....10320

Employer's ID Number.....61-1275981

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on Page 2 of this annual statement. \$ 932,172,474

2. Ten largest exposures to a single issuer/borrower/investment:

1	2	3	4
Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets
2.01 Citibank Credit Card Issuance Trust	ABS	\$ 10,858,217	1.165 %
2.02 Federal Home Loan Mortgage Corporation	MBS	\$ 7,612,223	0.817 %
2.03 Apple Inc.	Equity, Bonds	\$ 6,656,506	0.714 %
2.04 JPMorgan Chase & Co.	Equity, Bonds	\$ 5,480,722	0.588 %
2.05 Federal Home Loan Mortgage Corporation	MBS	\$ 5,337,357	0.573 %
2.06 Federal National Mortgage Association	MBS	\$ 5,236,996	0.562 %
2.07 Federal National Mortgage Association	MBS	\$ 5,136,957	0.551 %
2.08 Chase Issuance Trust	ABS	\$ 4,805,412	0.516 %
2.09 Federal National Mortgage Association	MBS	\$ 4,687,869	0.503 %
2.10 Federal Home Loan Mortgage Corporation	MBS	\$ 4,659,832	0.500 %

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC designation:

	1	2
<u>Bonds</u>		
3.01 NAIC-1	\$ 848,759,792	89.382 %
3.02 NAIC-2	\$ 92,532,391	9.927 %
3.03 NAIC-3	\$	0.000 %
3.04 NAIC-4	\$	0.000 %
3.05 NAIC-5	\$	0.000 %
3.06 NAIC-6	\$	0.000 %
<u>Preferred Stocks</u>		
3.07 PIRP-1	\$	0.000 %
3.08 PIRP-2	\$	0.000 %
3.09 PIRP-3	\$	0.000 %
3.10 PIRP-4	\$	0.000 %
3.11 PIRP-5	\$	0.000 %
3.12 PIRP-6	\$	0.000 %

4. Assets held in foreign investments:

4.01 Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?

Yes ☐ No ☒

If response to 4.01 above is yes, responses are not required for interrogatories 5-10.

4.02 Total admitted assets held in foreign investments	\$ 90,182,185	9.674 %
4.03 Foreign-currency-denominated investments	\$	0.000 %
4.04 Insurance liabilities denominated in that same foreign currency	\$	0.000 %

5. Aggregate foreign investment exposure categorized by NAIC sovereign designation:

	1	2
5.01 Countries designated NAIC-1	\$ 75,094,841	8.055 %
5.02 Countries designated NAIC-2	\$ 14,247,662	1.528 %
5.03 Countries designated NAIC-3 or below	\$ 849,683	0.091 %

6. Largest foreign investment exposures by country, categorized by the country's NAIC sovereign designation:

	1	2
<u>Countries designated NAIC-1:</u>		
6.01 Country 1: Australia	\$ 14,385,127	1.543 %
6.02 Country 2: United Kingdom	\$ 14,238,419	1.527 %
<u>Countries designated NAIC-2:</u>		
6.03 Country 1: Mexico	\$ 4,978,307	0.534 %
6.04 Country 2: Brazil	\$ 4,117,906	0.442 %
<u>Countries designated NAIC-3 or below:</u>		
6.05 Country 1: Curacao	\$ 849,683	0.091 %
6.06 Country 2:	\$	0.000 %

	1	2
f. Aggregate unhedged foreign currency exposure:	\$	0.000 %

8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign designation:	1	2
8.01 Countries designated NAIC-1:	\$	0.000 %
8.02 Countries designated NAIC-2:	\$	0.000 %
8.03 Countries designated NAIC-3 or below:	\$	0.000 %

9. Largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign designation:		
Countries designated NAIC-1:	1	2
9.01 Country 1:	\$	0.000 %
9.02 Country 2:	\$	0.000 %
Countries designated NAIC-2:		
9.03 Country 1:	\$	0.000 %
9.04 Country 2:	\$	0.000 %
Countries designated NAIC-3 or below:		
9.05 Country 1:	\$	0.000 %
9.06 Country 2:	\$	0.000 %

10. Ten largest non-sovereign (i.e. non-governmental) foreign issues:

	1	2	3	4
	Issuer	NAIC Designation		
10.01	Daimler Finance North America LLC	1FE	\$ 3,157,384	0.339 %
10.02	Shell International Finance B.V.	1FE	\$ 2,994,691	0.321 %
10.03	América Móvil, S.A.B. de C.V.	1FE	\$ 2,967,767	0.318 %
10.04	Mazda Bank Limited	1FE	\$ 2,955,437	0.317 %
10.05	Sumitomo Mitsui Banking Corporation	1FE	\$ 2,696,699	0.289 %
10.06	Lloyds Bank PLC	1FE	\$ 2,504,709	0.269 %
10.07	Westpac Banking Corporation	1FE	\$ 2,498,876	0.268 %
10.08	Toyota Motor Credit Corporation	1FE	\$ 2,497,680	0.268 %
10.09	National Australia Bank Limited	1FE	\$ 2,466,524	0.265 %
10.10	BP Capital Markets PLC	1FE	\$ 2,365,636	0.254 %

11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure:

11.01 Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets?	Yes <input checked="" type="checkbox"/> No <input type="checkbox"/>
If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11.	
11.02 Total admitted assets held in Canadian investments:	\$ 0.000 %
11.03 Canadian currency-denominated investments:	\$ 0.000 %
11.04 Canadian-denominated insurance liabilities:	\$ 0.000 %
11.05 Unhedged Canadian currency exposure:	\$ 0.000 %

12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions:

12.01 Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets?			
If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.			
	1	2	3
12.02 Aggregate statement value of investments with contractual sales restrictions:	\$		0.000 %
Largest three investments with contractual sales restrictions:			
12.03	\$		0.000 %
12.04	\$		0.000 %
12.05	\$		0.000 %

13. Amounts and percentages of admitted assets held in the ten largest equity interests:

13.01 Are assets held in equity interest less than 2.5% of the reporting entity's total admitted assets?			
If response to 13.01 above is yes, responses are not required for the remainder of Interrogatory 13.			
	1	2	3
	Name of Issuer		
13.02	Apple Inc.	\$ 3,056,422	0.328 %
13.03	HCP Inc.	\$ 3,007,249	0.323 %
13.04	Microsoft Corporation	\$ 2,615,135	0.281 %
13.05	Lockheed Martin Corporation	\$ 2,570,810	0.276 %
13.06	Wells Fargo & Company	\$ 2,092,918	0.225 %
13.07	Altria Group Inc.	\$ 2,080,179	0.223 %
13.08	JPMorgan Chase & Co.	\$ 1,985,100	0.213 %
13.09	Intel Corporation	\$ 1,940,428	0.208 %
13.10	Johnson & Johnson	\$ 1,894,808	0.203 %
13.11	Windstream Holdings Inc.	\$ 1,830,104	0.196 %

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:

14.01 Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets?			
If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.			
	1	2	3
14.02 Aggregate statement value of investments held in nonaffiliated, privately placed equities:	\$		0.000 %
Largest three investments held in nonaffiliated, privately placed equities:			
14.03	\$		0.000 %
14.04	\$		0.000 %
14.05	\$		0.000 %

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:

15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 15.01 above is yes, responses are not required for the remainder of Interrogatory 15.

	1	2	3
15.02 Aggregate statement value of investments held in general partnership interests	\$		0.000 %
Largest three investments in general partnership interests:			
15.03	\$		0.000 %
15.04	\$		0.000 %
15.05	\$		0.000 %

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

	1	2	3
Type (Residential, Commercial, Agricultural)			
16.02	\$		0.000 %
16.03	\$		0.000 %
16.04	\$		0.000 %
16.05	\$		0.000 %
16.06	\$		0.000 %
16.07	\$		0.000 %
16.08	\$		0.000 %
16.09	\$		0.000 %
16.10	\$		0.000 %
16.11	\$		0.000 %

Amount and percentage of the reporting entity's total admitted assets held in the following categories of mortgage loans:

	Loans		
16.12 Construction loans	\$		0.000 %
16.13 Mortgage loans over 90 days past due	\$		0.000 %
16.14 Mortgage loans in the process of foreclosure	\$		0.000 %
16.15 Mortgage loans foreclosed	\$		0.000 %
16.16 Restructured mortgage loans	\$		0.000 %

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

Loan-to-Value	Residential		Commercial		Agricultural	
	1	2	3	4	5	6
17.01 above 95%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.02 91% to 95%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.03 81% to 90%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.04 71% to 80%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.05 below 70%	\$	0.000 %	\$	0.000 %	\$	0.000 %

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

18.01 Are assets held in real estate reported less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

Largest five investments in any one parcel or group of contiguous parcels of real estate:

	2	3
Description		
18.02	\$	0.000 %
18.03	\$	0.000 %
18.04	\$	0.000 %
18.05	\$	0.000 %
18.06	\$	0.000 %

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans.

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the reporting entity's admitted assets?

Yes [X] No []

If response to 19.01 is yes, responses are not required for the remainder of Interrogatory 19.

	1	2	3
19.02 Aggregate statement value of investments held in mezzanine real estate loans	\$		0.000 %
Largest three investments held in mezzanine real estate loans:			
19.03	\$		0.000 %
19.04	\$		0.000 %
19.05	\$		0.000 %

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	At Year-End		At End of Each Quarter		
	1	2	1st Qtr	2nd Qtr	3rd Qtr
20.01 Securities lending agreements (do not include assets held as collateral for such transactions)	\$ 26,891,049	2.885 %	\$	\$	\$ 19,611,630
20.02 Repurchase agreements	\$	0.000 %	\$	\$	\$
20.03 Reverse repurchase agreements	\$	0.000 %	\$	\$	\$
20.04 Dollar repurchase agreements	\$	0.000 %	\$	\$	\$
20.05 Dollar reverse repurchase agreements	\$	0.000 %	\$	\$	\$

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps and floors:

	<u>Owned</u>		<u>Written</u>	
	1	2	3	4
21.01 Hedging.....	\$	0.000 %	\$	0.000 %
21.02 Income generation.....	\$	0.000 %	\$	0.000 %
21.03 Other.....	\$	0.000 %	\$	0.000 %

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

	<u>At Year-End</u>		<u>At End of Each Quarter</u>		
	1	2	1st Qtr	2nd Qtr	3rd Qtr
22.01 Hedging.....	\$	0.000 %	\$	\$	\$
22.02 Income generation.....	\$	0.000 %	\$	\$	\$
22.03 Replications.....	\$	0.000 %	\$	\$	\$
22.04 Other.....	\$	0.000 %	\$	\$	\$

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

	<u>At Year-End</u>		<u>At End of Each Quarter</u>		
	1	2	1st Qtr	2nd Qtr	3rd Qtr
23.01 Hedging.....	\$	0.000 %	\$	\$	\$
23.02 Income generation.....	\$	0.000 %	\$	\$	\$
23.03 Replications.....	\$	0.000 %	\$	\$	\$
23.04 Other.....	\$	0.000 %	\$	\$	\$

**KENTUCKY EMPLOYERS' MUTUAL
INSURANCE AUTHORITY dba KENTUCKY
EMPLOYERS' MUTUAL INSURANCE**
Statutory Basis Financial Statements and
Supplementary Information

*Years Ended December 31, 2013 and 2012
with Report of Independent Auditors*

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Report of Independent Auditors

Board of Directors

Kentucky Employers' Mutual Insurance Authority dba

Kentucky Employers' Mutual Insurance

Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI), which comprise the statements of admitted assets, liabilities and policyholder surplus - statutory basis as of December 31, 2013 and 2012, and the related statements of income and changes in policyholder surplus - statutory basis, and cash flows - statutory basis for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 2 of the financial statements, the financial statements are prepared by KEMI on the statutory basis of accounting using accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of the Department of Insurance of the Commonwealth of Kentucky.

The effects on the financial statements of the variances between the statutory basis of accounting described in Note 2 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of KEMI as of December 31, 2013 and 2012, or the results of its operations or its cash flows for the years then ended.

Opinion on Regulatory Basis of Accounting

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholder surplus of KEMI as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with the statutory basis of accounting prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky described in Note 2.

Other Matters

Required Supplementary Information

Statutory basis of accounting principles prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky require that the accompanying Summary Investment Schedule and Supplementary Investment Risks Interrogatories (Supplementary Information) be presented to supplement the basic statutory basis financial statements. Such information, although not a part of the basic statutory basis financial statements, is required by the statutory basis of accounting principles prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky who consider it to be an essential part of the financial reporting for placing the basic statutory basis financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic statutory basis financial statements, and other knowledge we obtained during our audit of the basic statutory basis financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Report of Independent Auditors, continued

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated March 28, 2014 on our consideration of KEMI's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering KEMI's internal control over financial reporting and compliance.

Dean Dotson Allen Ford, PLLC

March 28, 2014
Lexington, Kentucky

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Admitted Assets, Liabilities and Policyholder Surplus - Statutory Basis

December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Admitted Assets		
Long-term bonds	\$ 666,594,483	\$ 641,731,088
Common stock	61,167,189	46,851,355
Cash, cash equivalents, and short-term investments	41,745,787	14,425,190
Investment income due and accrued	5,592,703	5,474,584
Premiums in course of collection	7,928,537	9,266,078
Premiums booked but deferred and not yet due	32,897,291	29,648,981
Reinsurance receivable on losses and loss adjustment expenses	75,227	266,027
Electronic data processing equipment at cost, less accumulated depreciation of \$3,251,754 and \$3,518,662 in 2013 and 2012, respectively	<u>201,315</u>	<u>220,793</u>
Total admitted assets	\$ <u>816,202,532</u>	\$ <u>747,884,096</u>
Liabilities and Policyholder Surplus		
Unpaid losses	\$ 490,503,015	\$ 459,374,586
Unpaid loss adjustment expenses	40,758,800	38,282,935
Commissions payable	8,528,187	7,386,907
Unearned premiums	69,024,930	59,286,900
Amounts withheld or retained for others	6,208,082	6,378,382
Reinsurance premiums paid in advance	(771,055)	(763,126)
Remittances and items not allocated	998,786	923,239
Policyholder dividend payable	-	37,058
Other liabilities	<u>4,575,246</u>	<u>3,883,902</u>
Total liabilities	619,825,991	574,790,783
Policyholder surplus	<u>196,376,541</u>	<u>173,093,313</u>
Total liabilities and policyholder surplus	\$ <u>816,202,532</u>	\$ <u>747,884,096</u>

See accompanying notes.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Statements of Income - Statutory Basis

Years ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Premiums earned:		
Direct	\$ 134,528,324	\$ 120,742,275
Assumed	4,681,713	4,138,145
Ceded	<u>(6,069,542)</u>	<u>(5,673,668)</u>
	133,140,495	119,206,752
Losses incurred:		
Direct	81,182,243	73,678,541
Assumed	2,924,543	2,071,716
Ceded	<u>1,395,731</u>	<u>9,341,171</u>
	85,502,517	85,091,428
Loss adjustment expenses, net of ceded	22,206,821	21,103,682
Commissions and brokerage fees	16,833,982	14,889,434
Other underwriting expenses	<u>16,353,946</u>	<u>14,146,474</u>
Total underwriting expenses	<u>140,897,266</u>	<u>135,231,018</u>
Net underwriting loss	(7,756,771)	(16,024,266)
Investment income, net of investment expenses of \$1,941,304 and \$1,636,110 in 2013 and 2012, respectively	23,198,095	24,776,323
Net realized capital gains	8,958,313	7,824,933
Bad debt and other expenses	<u>(1,148,662)</u>	<u>(2,873,523)</u>
Net income before policyholder dividend	23,250,975	13,703,467
Policyholder dividend	<u>6,428,792</u>	<u>4,698,329</u>
Net income	<u>\$ 16,822,183</u>	<u>\$ 9,005,138</u>

See accompanying notes.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Statements of Changes in Policyholder Surplus - Statutory Basis

Years ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Policyholder surplus, beginning of year	\$ 173,093,313	\$ 159,587,775
Net income	16,822,183	9,005,138
Change in net unrealized gains on investments	5,937,754	1,210,377
Change in non-admitted assets	549,949	3,249,223
Change in provision for reinsurance	<u>(26,658)</u>	<u>40,800</u>
Policyholder surplus, end of year	\$ <u>196,376,541</u>	\$ <u>173,093,313</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Cash Flows - Statutory Basis

Years ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Premiums collected, net of reinsurance	\$ 142,191,877	\$ 122,028,481
Investment income, net of investment expenses	24,804,834	26,210,114
Miscellaneous expenses	(1,148,662)	(2,873,523)
Benefit and loss related payments	(54,183,289)	(65,881,016)
Commissions, expenses paid and aggregate write-ins	(50,754,613)	(46,943,616)
Dividend paid to policyholders	<u>(6,465,850)</u>	<u>(6,550,485)</u>
Net cash provided by operating activities	54,444,297	25,989,955
Cash flows from investing activities:		
Proceeds from investments sold or matured	189,407,673	235,882,906
Cost of investments acquired	<u>(215,400,125)</u>	<u>(272,244,175)</u>
Net cash used in investing activities	(25,992,452)	(36,361,269)
Cash flows from miscellaneous activities:		
Other cash applied	<u>(1,131,248)</u>	<u>(320,482)</u>
Net change in cash, cash equivalents, and short-term investments	27,320,597	(10,691,796)
Cash, cash equivalents, and short-term investments, beginning of year	<u>14,425,190</u>	<u>25,116,986</u>
Cash, cash equivalents, and short-term investments, end of year	<u>\$ 41,745,787</u>	<u>\$ 14,425,190</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements

1. Description of Organization

Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) is a non-profit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). KEMI was established by legislation of the Commonwealth enacted April 4, 1994 to serve as a competitive state fund for the purpose of providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage as required by state law. KEMI began writing business effective September 1, 1995.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying statutory basis financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky (the Department), which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America (GAAP). Prescribed statutory accounting policies include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting policies other than those prescribed. The NAIC *Accounting Practices and Procedures Manual* (NAIC SAP) (version effective March 1, 2013) has been adopted as a component of prescribed practices by the Commonwealth of Kentucky. KEMI does not employ any practices not prescribed by the NAIC or the Department of Insurance of the Commonwealth of Kentucky in the preparation of its statutory financial statements. The more significant differences between statutory accounting practices and GAAP are as follows:

a. Investments in bonds with an NAIC rating of 1 or 2 are carried at NAIC determined value or amortized cost, whereas bonds with a NAIC rating of 3 through 6 are assigned specific year-end values by the NAIC and are written down to Securities Valuation Office (SVO) assigned values (if less than amortized cost) by charging statutory policyholder surplus. Under GAAP, bonds are classified into three categories: held to maturity, available for sale, and trading. Bonds held to maturity are stated at amortized cost; bonds available for sale are stated at fair value and the resulting unrealized gains or losses, net of applicable income taxes, are charged or credited to policyholder surplus; and bonds held for trading are reported at fair value and the resulting unrealized gains and losses are reported in earnings, net of related taxes.

The fair value of investments on a statutory basis is determined by the SVO, whereas for GAAP, the fair value of investments is determined based on the expected exit price.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

For loan-backed and structured securities, if the company determines that a security is impaired and they intend to sell the security or no longer have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security shall be written down to fair value. For statutory purposes, if the company subsequently changes their assertion, and now believe they do not intend to sell the security and have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security will continue to be carried at the lower of cost or market with any future decreases in fair value charged through operations until the security is disposed. For GAAP purposes, once the company alters their assertion, that security's amortized cost basis will not be decreased for future reductions in fair value unless an other than temporary impairment is determined to have occurred.

Also, for GAAP purposes, other-than-temporary impairment losses (related to non loan-backed and structured securities) related to debt securities are bifurcated between credit and non-credit, where for statutory purposes the total other-than-temporary impairment loss is reported in earnings.

b. Assets having economic value other than those that can be used to fulfill policyholder obligations are categorized as "nonadmitted assets" and are not permitted to be included in the statutory financial statements of admitted assets, liabilities, and policyholder surplus, whereas, for GAAP, these assets are recognized in the balance sheet. Included with nonadmitted assets are furniture, equipment and supplies, prepaid expenses, certain receivables and other items that do not meet statutory criteria for admitted assets.

c. Receivables over 90 days outstanding are not admitted to the statutory financial statements and charged to policyholder surplus, whereas, for GAAP, the company assesses the collectability of premiums receivable and any charge is to the income statement.

d. The statutory financial statements are presented net of the effects of reinsurance, whereas, for GAAP, the financial statements are presented gross of the effects of reinsurance.

e. Guaranty fund assessments are generally available for recoupment from policyholders and as such, amounts assessed are recorded as a recoverable asset. Under GAAP, these assessments against the company are expensed when incurred and subsequently recorded as revenue when collected from the policyholders. Assessments against the policyholders are shown as a liability.

f. Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and, to the extent recoverable, amortized with deferred policy acquisition costs, as required under GAAP.

g. Comprehensive income is not determined for statutory reporting purposes, whereas, for GAAP, such income is recognized.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

h. Costs incurred in connection with acquiring new insurance business, including commissions, are charged against statutory earnings as such costs are incurred, while, under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective periods covered by the related policies.

i. A statutory liability has been established and charged to policyholder surplus for amounts due from unauthorized reinsurers in excess of letters of credit, funds held, and premiums payable. Under GAAP, no such liability is provided.

j. The statutory statement of cash flows differs in certain respects from the presentation required within GAAP literature, including the presentation of changes in cash and short-term investments instead of cash and cash equivalents.

k. The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements that KEMI files with the NAIC and the state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP reporting.

The effect of the differences between statutory accounting practices and accounting principles generally accepted in the United States of America has not been determined, but is presumed to be material.

Risks and Uncertainties

Certain risks and uncertainties are inherent to KEMI's day-to-day operations and to the process of preparing its statutory basis financial statements. The more significant of those risks and uncertainties are presented below and throughout the notes to the statutory basis financial statements.

Use of Estimates - The preparation of the statutory basis financial statements requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statutory basis financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of unpaid losses and loss adjustment expenses. In connection with the determination of this liability, management uses the methodology described in *Unpaid Losses and Loss Adjustment Expenses* later in this footnote. While management uses the best information available to estimate unpaid losses and loss adjustment expenses, future changes to the liability may be necessary based on claims experience and changing claims frequency and severity conditions, as well as changes in doctrines of legal liability and damage awards in Kentucky. The future changes will be charged or credited to expense when they occur.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Loss Reserves - KEMI estimates losses and loss adjustment expenses (LAE) based on the accumulation of case estimates and loss reports, as well as estimates of incurred but not reported (IBNR) losses, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported and unreported claims and incidents. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Actual results could differ from these estimates.

Reinsurance - Reinsurance contracts do not relieve KEMI from its obligations to insureds. Failure of reinsurers to honor their obligations could result in losses to KEMI. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Management believes that any liability arising from this contingency would not be material to KEMI's financial position.

Investment Risk - KEMI is exposed to risks that issuers of securities owned by KEMI will default or that interest rates will change and cause a decrease in the value of its investments. With mortgage-backed securities, KEMI is exposed to credit risk and prepayment risk.

As interest rates decline, the velocity at which these securities pay down the principal will increase. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

KEMI maintains balances at financial institutions that may exceed federally insured limits; however, it also utilizes repurchase agreements and money market funds to mitigate this risk. KEMI's management continually evaluates the financial stability of these financial institutions, and does not believe they are exposed to unnecessary risk.

Since most of KEMI's investments consist of securities that are traded in the public securities markets, they are subject to risk related to fluctuations in overall market performance and are potentially subject to heightened levels of market risk attributable to issuer, industry, and geographic region concentrations. KEMI's investment portfolio is regularly reviewed and the extent of its diversification is considered in the context of statutory requirements and other risk management and performance objectives.

External Factors - KEMI is highly regulated by the state in which it is domiciled. Such regulations, among other things, limit the amount of dividends and impose restrictions on the amount and types of investments. In addition, from time to time, KEMI may be affected by changes in federal regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), or the Patient Protection and Affordable Care Act (PPACA). Additionally, the PPACA contained an amendment with specific language related to black lung claims (the Byrd Amendment). KEMI continues to monitor the impact of such regulations and will assess any potential impact of these changes.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Risk-Based Capital - The NAIC has developed property-casualty risk-based capital (RBC) standards that relate an insurer's reported statutory capital and policyholder surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to protect KEMI from the various risks that it faces. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. KEMI continues to monitor its internal capital requirements and the NAIC's RBC requirements. KEMI has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that KEMI's capital levels are sufficient to support the level of risk inherent in its operations.

Investments

Investments, excluding residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies, are stated at values prescribed by the NAIC's Security Valuation Office (SVO), which generally are as follows:

Non loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method with bonds containing call provisions being amortized to the call or maturity date, whichever results in a lower asset value. Loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method including anticipated prepayments. Bonds rated 3 through 6 are carried at fair value with the change run through policyholder surplus.

Investments in residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies utilize a financial model commissioned by the NAIC to determine credits ratings, and ultimately the NAIC designation/rating. This financial model requires a two step process. KEMI first determines the initial rating designation based upon each security's amortized cost in relation to security specific prescribed break points. This initial rating designation determines whether the security will be stated at amortized cost or fair value, based on the same criteria noted in the preceding paragraph. (The lower the amortized cost relative to par, the higher the NAIC designation, and the more likely the security will be carried at amortized cost.) If the security is to be carried at fair value, KEMI then determines the final rating designation based upon each security's fair value in relation to the same security specific prescribed break points used in the first step. If the security is to be carried at amortized cost, the final designation remains the same as what was determined in the first step. The final designation is used for RBC purposes as well as for NAIC designation disclosure purposes.

Investments in preferred stocks with an NAIC rating designation of 1 or 2 are stated at amortized cost; all other preferred stocks are stated at the lesser of amortized cost or fair value.

Investments in common stocks are stated at fair value with unrealized gains and losses being reported as a separate component of unassigned policyholder surplus.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Investments, continued

Realized gains or losses are determined on the specific-identification method. Investment income is recognized as earned, net of related investment expenses. Bond premiums and discounts are amortized by the scientific-yield method and are charged or credited to net investment income. For mortgage-backed securities, KEMI anticipates prepayments utilizing published data in applying interest income.

The assessment of other-than-temporary impairments is performed on a case-by-case basis. Factors considered by management in determining whether an other-than-temporary impairment exists (in other than loan-backed or structured securities) include: the financial condition, business prospects and creditworthiness of the issuer, the length of time and extent to which fair value has been less than cost for equity securities or amortized cost for fixed income securities, and KEMI's intent and ability to retain such investments until the fair value recovers. If it is determined that the decline in fair market value is other than temporary, the carrying amount of the investment is written down to fair value as its new basis and the amount of the write-down is recorded as a realized loss.

For loan-backed or structured securities, factors considered by management in determining whether an other-than-temporary impairment exists include: KEMI's stated intent to not sell, KEMI's ability to hold such investments until the fair value recovers, and the discounted cash flows of the security based on the yield at the date of acquisition. If KEMI intends to sell or if KEMI does not have the ability and intent to hold the security for a period of time sufficient to recover its amortized cost basis, an other-than-temporary impairment exists, and the security is written down to fair value with the amount of the write-down recorded as a realized loss. If KEMI does not intend to sell the security and has the ability and intent to hold the security for a period of time sufficient to recover the amortized cost basis, KEMI calculates the cash flows expected to be collected. In this calculation, KEMI compares the present value of cash flows expected to be collected, discounted at the security's effective interest rate at date of purchase, to the amortized cost basis. If the present value of cash flows is less than the amortized cost basis, a realized loss is recorded for the difference. The present value of cash flows then becomes the new cost basis.

KEMI uses the prospective method to accrete the amortized cost basis to the ultimate expected cash flows.

Premiums

Premiums are earned on the daily pro-rata method over the policy period and are stated after deduction for reinsurance. Unearned premiums represent the portion of initial premiums written that are applicable to the unexpired terms of policies in force. Initial premiums are recorded as premiums written on the policy effective date except for certain premiums that are recorded on an installment basis. Any subsequent additional premiums or refunds that occur as a result of policy audits are recorded as written premiums at the time the policy audits are finalized. Earned but unbilled premiums represent management's estimate of future audit premiums and are included in premiums booked but deferred and not yet due.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Premiums, continued

Premiums in course of collection which are customer obligations due under normal terms requiring payment by the policy due date, and premiums booked but deferred and not yet due are valued at their carrying amount, which approximates fair value. Receivables over 90 days outstanding are not admitted to the statutory basis financial statements.

Unpaid Losses and Loss Adjustment Expenses

The estimated liability for losses is based on the accumulation of case estimates for claims and incidents reported, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported claims and incidents. Also included in the liability are estimates of incurred but not reported losses based on historical experience adjusted for current trends. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Estimates for loss and related LAE are made without regard to the time value of money.

Management believes that the provisions for losses and LAE are adequate to cover the net cost of claims incurred and incidents reported; however, the provisions are necessarily based upon estimates and, therefore, the ultimate liability may be less than or exceed such estimates. As adjustments become necessary in these estimates, such adjustments are reflected in the results of operations in the period in which they are determined.

The reserves for unpaid losses are net of anticipated subrogation.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums, losses, and loss adjustment expenses are reported net of reinsured amounts. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. KEMI holds funds and collateral as security under reinsurance agreements in the form of letters of credit for any reinsurers not subject to the regulation of the Kentucky Commissioner of Insurance. In the opinion of management, all amounts due from reinsurers at December 31, 2013 and 2012 are recoverable.

Cash, Cash Equivalents, and Short-Term Investments

Cash, cash equivalents, and short-term investments consist of cash on deposit with financial institutions and investments with original maturities of less than one year at the date of acquisition. These investments are carried at cost, which approximates fair value.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Concentrations of Geographic and Credit Risk

All of KEMI's total direct gross written premiums of \$143,753,265 for the year ended December 31, 2013 were for insureds in Kentucky.

The credit quality of the long-term bond portfolio at December 31, 2013 is presented is as follows:

	<u>Carrying Value</u>	<u>Percentage</u>
Class 1 - highest quality	\$ 557,727,939	83.7 %
Class 2 - high quality	<u>108,866,544</u>	<u>16.3</u>
Total	<u>\$ 666,594,483</u>	<u>100 %</u>

Bonds with ratings from AAA to BBB as assigned by Standard & Poor's Corporation are generally considered as investment grade securities. Some securities issued by the U.S. government or an agency thereof are not rated but are considered to be investment grade. The NAIC regards U.S. Treasuries and agencies and all A ratings as Class 1 (highest quality), BBB ratings as Class 2 (high quality), BB ratings as Class 3 (medium quality), B ratings as Class 4 (low quality), C ratings as Class 5 (lower quality), and D ratings as Class 6 (in or near default).

Property and Equipment

Electronic data processing equipment, including operating software, is stated at cost less accumulated depreciation. Depreciation expense on such property was \$218,886 and \$252,677 in 2013 and 2012, respectively. Furniture, office equipment, and application software are non-admitted assets under statutory accounting practices. Depreciation expense on such property was \$154,983 and \$277,612 in 2013 and 2012, respectively.

Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. Gains and losses on the sale of property and equipment are recorded in the year of disposition. Maintenance and repairs are expensed as incurred; replacements and betterments are capitalized.

Advertising

KEMI expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2013 and 2012, was \$1,319,518 and \$1,072,523, respectively.

Reclassifications

Certain amounts of an immaterial nature in the 2012 financial statements have been reclassified to conform to the 2013 presentation with no net impact to net loss or policyholder surplus.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Subsequent Events

All of the effects of subsequent events that provide additional evidence about conditions that existed at the statement of admitted assets, liabilities and policyholder surplus date, including the estimates inherent in the process of preparing the statutory basis financial statements, are recognized in the statutory basis financial statements. KEMI does not recognize subsequent events that provide evidence about conditions that did not exist at the statement of admitted assets, liabilities and policyholder surplus date but arose after, but before the statutory basis financial statements are available to be issued. In some cases, nonrecognized subsequent events are disclosed to keep the statutory basis financial statements from being misleading.

Management has evaluated subsequent events for accounting and disclosure requirements through March 28, 2014, the date that the statutory basis financial statements were available to be issued. There were no events occurring during the evaluation period that require recognition or disclosure in the statutory basis financial statements.

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Notes to the Statutory Basis Financial Statements, continued

3. Investments

Long-Term Bonds

The statement value, gross unrealized gains, gross unrealized losses, and the estimated fair value of investments in long-term bonds are summarized as follows:

	Statement <u>Value</u>	Gross Unrealized <u>Gains</u>	Gross Unrealized <u>Losses</u>	Estimated Fair <u>Value</u>
As of December 31, 2013:				
U.S. government securities	\$ 51,923,528	\$ 214,018	\$ (3,267,780)	\$ 48,869,766
U.S. agency mortgage-backed securities	3,190,387	95,010	-	3,285,397
U.S. special revenue bonds	163,784,396	4,735,914	(2,879,686)	165,640,624
Commercial mortgage-backed securities	45,334,942	1,057,774	(787,319)	45,605,397
Commercial asset-backed securities	42,270,807	591,260	(86,487)	42,775,580
Other corporate bonds	351,785,590	15,144,818	(6,577,287)	360,353,121
All other bonds	<u>8,304,833</u>	<u>183,639</u>	<u>(81,025)</u>	<u>8,407,447</u>
	<u>\$ 666,594,483</u>	<u>\$ 22,022,433</u>	<u>\$ (13,679,584)</u>	<u>\$ 674,937,332</u>
As of December 30, 2012:				
U.S. government securities	\$ 52,251,771	\$ 1,420,455	\$ (64,106)	\$ 53,608,120
U.S. agency mortgage-backed securities	4,297,359	175,722	-	4,473,081
U.S. special revenue bonds	155,544,786	10,296,642	(100,125)	165,741,303
Commercial mortgage-backed securities	40,291,337	2,925,662	-	43,216,999
Commercial asset-backed securities	41,421,945	1,008,833	(1,033)	42,429,745
Other corporate bonds	340,613,526	30,775,397	(159,881)	371,229,042
All other bonds	<u>7,310,364</u>	<u>764,176</u>	<u>-</u>	<u>8,074,540</u>
	<u>\$ 641,731,088</u>	<u>\$ 47,366,887</u>	<u>\$ (325,145)</u>	<u>\$ 688,772,830</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Long-Term Bonds, continued

The carrying value and estimated fair value of long-term bonds at December 31, 2013, by contractual maturity, are as follows. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Statement Value	Estimated Fair Value
Less than one year	\$ 21,175,202	\$ 21,442,340
One year through five years	187,667,971	196,008,326
Six years through ten years	249,204,867	249,919,765
After ten years	<u>208,546,443</u>	<u>207,566,901</u>
	<u>\$ 666,594,483</u>	<u>\$ 674,937,332</u>

Proceeds from sales and maturities of bonds during 2013 and 2012 were \$143,229,108 and \$209,465,423, respectively. Gross gains of \$1,708,379 and \$6,292,820, and gross losses of \$588,114 and \$208,873 were realized on those sales in 2013 and 2012, respectively.

Common Stocks

Gross unrealized capital gains and losses on common stocks are included in policyholder surplus as follows:

	<u>2013</u>	<u>2012</u>
Cost	\$ 49,132,911	\$ 40,754,831
Gross unrealized capital gains	12,454,102	7,236,111
Gross unrealized capital losses	<u>(419,824)</u>	<u>(1,139,587)</u>
Net unrealized capital gain	<u>12,034,278</u>	<u>6,096,524</u>
Fair value	<u>\$ 61,167,189</u>	<u>\$ 46,851,355</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment

The following table illustrates the gross unrealized losses and fair value of investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment type and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2013 and 2012:

	December 31, 2013					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. government	\$ 37,862,891	\$ (2,976,583)	\$ 2,707,969	\$ (291,197)	\$ 40,570,860	\$ (3,267,780)
U.S. special revenue	71,875,549	(2,780,685)	2,155,793	(99,001)	74,031,342	(2,879,686)
Commercial mortgage-backed	15,891,341	(681,585)	1,127,156	(105,734)	17,018,497	(787,319)
Commercial asset-backed	14,061,731	(86,487)	-	-	14,061,731	(86,487)
Other corporate bonds	113,755,511	(5,994,188)	6,814,247	(583,099)	120,569,758	(6,577,287)
All other bonds	2,236,846	(81,025)	-	-	2,236,846	(81,025)
Equity securities	<u>5,164,815</u>	<u>(419,824)</u>	<u>-</u>	<u>-</u>	<u>5,164,815</u>	<u>(419,824)</u>
Total	<u>\$ 260,848,684</u>	<u>\$ (13,020,377)</u>	<u>\$ 12,805,165</u>	<u>\$ (1,079,031)</u>	<u>\$ 273,653,849</u>	<u>\$ (14,099,408)</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

	December 31, 2012					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. government	\$ 8,476,015	\$ (64,106)	\$ -	\$ -	\$ 8,476,015	\$ (64,106)
U.S. agency mortgage-backed	5,878,591	(69,644)	1,882,179	(30,481)	7,760,770	(100,125)
Commercial asset-backed	151,398	(1,033)	-	-	151,398	(1,033)
Other corporate bonds	20,471,065	(159,881)	-	-	20,471,065	(159,881)
Equity securities	<u>10,199,214</u>	<u>(815,301)</u>	<u>1,206,138</u>	<u>(324,286)</u>	<u>11,405,352</u>	<u>(1,139,587)</u>
Total	<u>\$ 45,176,283</u>	<u>\$ (1,109,965)</u>	<u>\$ 3,088,317</u>	<u>\$ (354,767)</u>	<u>\$ 48,264,600</u>	<u>\$ (1,464,732)</u>

KEMI evaluates impairment at each reporting period for each of the securities (other than loan-backed or structured securities) whereby the fair value of the investment is less than its amortized cost. It is expected that the securities would not be settled at a price less than the amortized cost of the investment, as KEMI has the ability and intent to hold the investment until there is not an unrealized loss on the investment. For valuing loan-backed and structured securities, KEMI's asset manager uses a proprietary model for loss assumptions and widely accepted models for prepayment assumptions with inputs from major third party data providers. Model assumptions are specific to asset class and collateral types and are regularly evaluated and adjusted where appropriate.

KEMI evaluated the credit ratings of these holdings, noting neither a significant deterioration since purchase nor other factors which may indicate an other-than-temporary impairment, such as the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and KEMI's intent and ability to hold the investment for a sufficient time in order to enable recovery of cost.

KEMI continues to review its investment portfolio under its impairment review policy. Given the fluctuating market conditions and the significant judgment involved, there is a continuing risk that further declines in fair value may occur and additional other than temporary impairments may be recorded in future periods.

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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements

The following table presents the carrying value and estimated fair value of KEMI's significant financial instruments at December 31, 2013 and 2012:

	<u>2013</u>		<u>2012</u>	
	<u>Statement</u> <u>Value</u>	<u>Estimated</u> <u>Fair Value</u>	<u>Statement</u> <u>Value</u>	<u>Estimated</u> <u>Fair Value</u>
Cash and short-term investments	\$ 41,745,787	\$ 41,745,787	\$ 14,425,190	\$ 14,425,190
U.S. government securities	51,923,528	48,869,766	52,251,771	53,608,120
U.S. agency mortgage-backed securities	3,190,387	3,285,397	4,297,359	4,473,081
U.S. special revenue bonds	163,784,396	165,640,624	155,544,786	165,741,303
Commercial mortgage-backed securities	45,334,942	45,605,397	40,291,337	43,216,999
Commercial asset-backed securities	42,270,807	42,775,580	41,421,945	42,429,745
Other corporate bonds	351,785,590	360,353,121	340,613,526	371,229,042
All other bonds	8,304,833	8,407,447	7,310,364	8,074,540
Equity securities	<u>61,167,189</u>	<u>61,167,189</u>	<u>46,851,355</u>	<u>46,851,355</u>
Total	<u>\$ 769,507,459</u>	<u>\$ 777,850,308</u>	<u>\$ 703,007,633</u>	<u>\$ 750,049,375</u>

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2013 and 2012. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these statutory financial statements since that date, and current estimates of fair value may differ significantly from the amounts presented herein.

The following methods and assumptions were used to estimate the fair value of each significant class of financial instruments for which it is practical to estimate that value:

Cash and short-term investments: Valued at cost. The carrying amounts reported in the statements of admitted assets, liabilities and policyholder surplus approximate their fair value due to their short maturity.

Bonds, loan-backed and structured securities, and common stocks: Valued at fair value by reference to identical trades in active markets and by a third party portfolio manager. Fair values are based on values published by the SVO, quoted market prices, or dealer quotes. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services, or in the case of private placements, are estimated by discounting the expected future cash flows using current market rates applicable to the yield, credit, and maturity of the investment.

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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

KEMI's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to fair values determined using unadjusted quote prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to fair values determined using unobservable inputs (Level 3). An asset's or liability's classification is determined based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that KEMI has the ability to access at the measurement date.

Level 2 – Valuations derived from inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as:

- a) Quoted prices for similar assets or liabilities in active markets.
- b) Quoted prices for identical or similar assets or liabilities in markets that are not active.
- c) Inputs other than quoted prices that are observable for the asset or liability.
- d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Valuations are derived from techniques that require significant unobservable inputs. The unobservable inputs reflect KEMI's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

KEMI holds common stocks that are measured at fair value on a recurring basis. In addition, KEMI sometimes holds certain financial assets, primarily certain bonds valued at the lower of cost or fair value in accordance with NAIC reporting guidelines and assets that are impaired during the current reporting period and carried at fair value, that are considered to be measured at fair value on a recurring basis. The following table summarizes KEMI's assets and liabilities measured at fair value on a recurring basis as follows:

	<u>Fair Value</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2013				
Investments:				
Common stock	\$ <u>61,167,189</u>	\$ <u>61,167,189</u>	\$ <u>-</u>	\$ <u>-</u>

	<u>Fair Value</u>	<u>Fair Value Measurements at Reporting Date Using</u>		
		<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 30, 2012				
Investments:				
Common stock	\$ <u>46,851,355</u>	\$ <u>46,851,355</u>	\$ <u>-</u>	\$ <u>-</u>

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Notes to the Statutory Basis Financial Statements, continued

5. Losses and Loss Adjustment Expenses

As of December 31, 2013 and 2012, the following table provides a reconciliation of the beginning and ending reserve balances for losses and loss adjustment expenses (LAE):

	<u>2013</u>	<u>2012</u>
Gross reserves for losses and LAE - beginning of year	\$ 549,645,904	\$ 538,700,239
Less reinsurance recoverables	<u>51,988,383</u>	<u>62,114,683</u>
Net reserves for losses and LAE - beginning of year	497,657,521	476,585,556
Provision for claims, related to:		
Current year	117,170,280	112,019,692
Prior years	<u>(9,460,942)</u>	<u>(5,824,582)</u>
Total incurred	107,709,338	106,195,110
Payments for claims, related to:		
Current year	(35,253,983)	(34,556,637)
Prior years	<u>(38,851,061)</u>	<u>(50,566,508)</u>
Total paid	<u>(74,105,044)</u>	<u>(85,123,145)</u>
Net reserves for losses and LAE - end of year	531,261,815	497,657,521
Plus reinsurance recoverables	<u>33,200,124</u>	<u>51,988,383</u>
Gross reserves for losses and LAE - end of year	<u>\$ 564,461,939</u>	<u>\$ 549,645,904</u>

As a result of changes in estimates of insured events in prior years, the liability for unpaid losses and loss adjustment expenses (net of reinsurance recoverables) decreased by \$9,460,942 and \$5,824,582 in 2013 and 2012, respectively. Estimated subrogation recoverable on unpaid losses was \$3,500,000 as of December 31, 2013 and 2012.

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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance

KEMI limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with various reinsurers under excess of loss agreements. These agreements cede premium on an earned basis. Ceded reinsurance is treated as the risk and liability of the assuming companies; however, these reinsurance contracts do not relieve KEMI from its original obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to KEMI; consequently, allowances are established for amounts deemed uncollectible, if any. KEMI evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

KEMI maintains Excess of Loss reinsurance coverage with unaffiliated reinsurers for losses and loss adjustment expenses in excess of \$2.5 million per occurrence and up to \$75 million per occurrence. The Excess of Loss reinsurance agreements apply to KEMI's net retained liability, covering direct and assumed business in force as of each effective date, as well as business new or renewed from the effective date through the end of the contract term. Unpaid losses and loss adjustment expenses as of December 31, 2013 and 2012 included estimated reinsurance recoverables under the Excess of Loss agreements of \$33,200,124 and \$51,988,383, respectively.

KEMI commuted certain Excess of Loss reinsurance treaties with unaffiliated reinsurers during 2013. KEMI recognized the amounts received from the reinsurers as a reduction of losses and loss adjustment expenses paid in the current year (thereby reducing net losses and loss adjustment expenses incurred). KEMI also increased its net reserves for losses and loss adjustment expenses (thereby increasing losses and loss adjustment expenses incurred) to recognize the effects of releasing the reinsurers from their obligations under the treaties. The net effect of these commutations was an increase in losses and loss adjustment expenses incurred of \$1,744,194.

KEMI maintains Terrorism Excess of Loss reinsurance through Lloyd's of London. This reinsurance covers the following for qualifying events: 100% coverage of \$7 million per occurrence in excess of \$18 million, and 15% coverage of \$125 million per occurrence in excess of \$25 million. For non-qualifying events, this reinsurance covers 100% of \$82 million per occurrence in excess of \$18 million. In no event shall the amount of net loss exceed \$82 million.

Effective April 1, 2011, KEMI engaged in an assumptive reinsurance arrangement with Zurich American Insurance Company through which KEMI offers multi-state coverage to its policyholders. Under the agreement, Zurich writes certain policies for which KEMI assumes 100% of the business. This coverage is only available to Kentucky-based businesses that have similar operations in other states. KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2013 and 2012 includes \$1,347,097 and \$693,957, respectively, related to this agreement. Zurich requires KEMI to maintain a standby letter of credit in the amount of \$10,400,000. The letter of credit is collateralized by U.S. Treasury Bonds.

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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

Effective January 1, 2007 through March 31, 2011, KEMI engaged in an assumptive reinsurance arrangement with Argonaut Insurance Company through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Argonaut wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective March 31, 2011, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2013 and 2012 includes \$552,269 and \$433,008, respectively, related to this agreement. Argonaut requires KEMI to maintain a standby letter of credit in the amount of \$1,906,662. The letter of credit is collateralized by U.S. Treasury Bonds.

Effective January 1, 2001 through December 31, 2002, KEMI engaged in an assumptive reinsurance arrangement with Fireman's Fund Insurance Company through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Fireman's Fund wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective December 31, 2002, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2013 and 2012 includes \$718,895 and \$764,702, respectively, related to this agreement. Fireman's Fund requires KEMI to maintain standby letters of credit in the amount of \$1,250,000. The letters of credit are collateralized by U.S. Treasury Bonds.

KEMI reported a provision for reinsurance in the amount of \$172,550 and \$145,892 at December 31, 2013 and 2012, respectively. This provision represents net recoverables from unauthorized (foreign) reinsurers for losses, loss adjustment expenses, and unearned premiums in excess of reinsurer deposits and letters of credit. When applicable, the provision for reinsurance also includes 20% of reinsurance receivables greater than 90 days past due or in dispute. None of KEMI's reinsurance receivables were overdue or in dispute at December 31, 2013 or 2012.

KEMI has the following unsecured net reinsurance recoverables outstanding for losses and loss adjustment expenses, paid and unpaid, including IBNR and unearned premium that individually exceeded 3% of policyholder surplus at December 31, 2013 and 2012:

Federal ID#:	Reinsurer:	AM Best Rating:	<u>2013</u>	<u>2012</u>
AA-1120337	Aspen Insurance UK Limited	A	\$ -	\$ 5,230,890
AA-1126435	Lloyd's Syndicate No. 435	A++	-	13,184,100

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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

A summary of reinsurance transactions for 2013 and 2012 is as follows:

	<u>2013</u>	<u>2012</u>
Written premiums:		
Direct	\$ 143,753,266	\$ 125,813,031
Assumed	5,139,759	4,083,658
Ceded	<u>(6,069,542)</u>	<u>(5,673,668)</u>
Net	\$ <u>142,823,483</u>	\$ <u>124,223,021</u>
Earned premiums:		
Direct	\$ 134,528,324	\$ 120,742,275
Assumed	4,681,713	4,138,145
Ceded	<u>(6,069,542)</u>	<u>(5,673,668)</u>
Net	\$ <u>133,140,495</u>	\$ <u>119,206,752</u>
Incurred losses and LAE:		
Direct	\$ 102,553,038	\$ 94,273,103
Assumed	3,543,865	2,594,812
Ceded	<u>1,612,435</u>	<u>9,327,195</u>
Net	\$ <u>107,709,338</u>	\$ <u>106,195,110</u>
Unearned premiums:		
Direct	\$ 67,214,805	\$ 57,934,821
Assumed	1,810,125	1,352,079
Ceded	<u>-</u>	<u>-</u>
Net	69,024,930	59,286,900
Adjustment for earned but unbilled premiums:	<u>(2,820,664)</u>	<u>(2,765,622)</u>
Net	\$ <u>66,204,266</u>	\$ <u>56,521,278</u>

KEMI has evaluated its reinsurance arrangements and believe they appropriately transfer risk in accordance with SSAP No. 62, *Property and Casualty Reinsurance*, and have therefore accounted for them as prospective reinsurance.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

7. Leases

KEMI leases space for its main office under a noncancellable operating lease which expires December 31, 2020. KEMI has two options to extend the lease, each for an additional 60 months following its expiration. Rental expense under this lease was \$1,013,912 and \$1,011,000 for 2013 and 2012, respectively. KEMI also leases space for a satellite office under a noncancellable operating lease which expires May 31, 2017. Rental expense under this lease was \$120,497 and \$113,377 for 2013 and 2012, respectively. The following is a summary of future minimum rental commitments for these leases:

2014	\$ 1,116,060
2015	1,119,133
2016	1,121,328
2017	1,049,928
2018	998,928
Thereafter	<u>1,997,856</u>
	<u>\$ 7,403,233</u>

8. Policyholder Dividend

During 2013, KEMI's Board of Directors approved a policyholder dividend in the amount of \$6.4 million. To be eligible, policyholders must have had a KEMI policy with a 2010 effective date and a total loss ratio of 75% or less. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status.

During 2012, KEMI's Board of Directors approved a policyholder dividend in the amount of \$6.3 million. The Board authorized management to apply \$1.6 million from a 2010 dividend that was not distributed due to policyholder ineligibility, creating a net dividend paid of \$4.7 million. To be eligible, policyholders must have had a KEMI policy with a 2009 effective date and a total loss ratio of 75% or less. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

9. Retirement Plans

Eligible KEMI employees participate in the Kentucky Employees Retirement System (KERS). KERS is a contributory defined benefit pension plan sponsored by Kentucky Retirement Systems, in which KEMI is a member. Employees hired prior to September 1, 2008 are required to contribute 5% of gross salary to KERS, while those hired on or after September 1, 2008 are required to contribute 6% of gross salary. Employers contribute at a rate determined by the Board of Kentucky Retirement Systems to maintain the financial soundness of KERS. The employer contribution rate, which may be adjusted annually based on the actuarial valuation of KERS, was 26.79% and 23.61% at December 31, 2013 and 2012, respectively. Total pension expense paid by KEMI during 2013 and 2012 was \$3,536,570 and \$2,868,789, respectively. As of June 30, 2013, the most recent actuarial valuation date, KERS's total actuarial liability was \$12,170,582,753 and the actuarial value of assets totaled \$3,141,779,660. The portion of this obligation and the related assets attributable to KEMI's employees is relatively insignificant in relation to the plan's totals.

Eligible KEMI employees may also participate in the Kentucky Deferred Compensation Plan, a defined contribution plan for which KEMI matches up to 50% of the first 6% of compensation deferred by employees. Total contributions made by KEMI were \$269,448 and \$245,386 in 2013 and 2012, respectively.

10. Federal Income Taxes

As described in Note 1, KEMI is a political subdivision of the Commonwealth and was created by legislation to serve as the insurer of last resort as well as a competitive force to stabilize the workers' compensation market in Kentucky. The Commonwealth provided KEMI's initial funding and continues to influence KEMI through Governor appointed board members and through the role of oversight. For these reasons, KEMI's management believes KEMI is a tax-exempt entity pursuant to Internal Revenue Code sections §115 and §501(c)(27) and therefore not subject to federal income taxes. Accordingly, the statutory basis financial statements do not include a provision for federal income taxes.

11. Contingencies

KEMI is involved in litigation and may become involved in potential litigation arising in the ordinary course of business. Additionally, KEMI may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope of originally contemplated policies. In the opinion of management, the effects, if any, of such litigation and published court decisions are not expected to be material to the statutory basis financial statements.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

12. Statutory Requirements

Under the insurance regulations of the Commonwealth of Kentucky, the amount of dividends that KEMI may pay to its policyholders is limited to the excess of actuarially determined minimum policyholder surplus requirements. Actuarially determined minimum policyholder surplus takes into consideration the company's present liabilities as well as management's expectation of future business volumes, claims activity and investment performance. The Commonwealth of Kentucky's statutory minimum policyholder surplus requirement is \$1,500,000.



Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Report of Independent Auditors

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the statutory basis financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI), as of and for the year ended December 31, 2013, and the related notes to the statutory basis financial statements, which collectively comprise KEMI's basic statutory basis financial statements, and have issued our report thereon dated March 28, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the statutory basis financial statements, we considered KEMI's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of KEMI's internal control. Accordingly, we do not express an opinion on the effectiveness of KEMI's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page 2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KEMI's statutory basis financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of statutory basis financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Dean Dotson Allen Ford, PLLC

March 28, 2014
Lexington, Kentucky



Awareness Letter

Board of Directors

Kentucky Employers' Mutual Insurance Authority dba

Kentucky Employers' Mutual Insurance

Lexington, Kentucky

We were engaged by Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) to perform annual audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of KEMI's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of the Commonwealth of Kentucky and the related rules and regulations of the Kentucky Department of Insurance that are applicable to audits of statutory financial statements of insurance entities. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of KEMI as to their conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky.

This letter is intended solely for the information and use of the board of directors and management of KEMI, the Department of Insurance of the Commonwealth of Kentucky and is not intended to be, and should not be, used for anyone other than these specified parties.

Dean Dorton Allen Ford, PLLC

March 28, 2014

Lexington, Kentucky



Qualification Letter

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

To the Board of Directors of Kentucky Employers' Mutual Insurance:

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the statutory financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) for the years ended December 31, 2013 and 2012, and have issued our report thereon dated March 28, 2014. In connection therewith, we advise you as follows:

- a) We are independent certified public accountants with respect to KEMI and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the Kentucky State Board of Accountancy.
- b) The engagement partner and the engagement manager, who are certified public accountants, have over 26 years and 3 years, respectively, of experience in public accounting and are experienced in auditing insurance entities. Members of the engagement team, most of whom have had experience in auditing insurance entities and 75% of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c) We understand that KEMI intends to file its audited statutory financial statements and our report thereon with the Department of Insurance of the Commonwealth of Kentucky (the Department) and that the commissioner of the Department will be relying on that information in monitoring and regulating the statutory financial condition of KEMI.

Although we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, KEMI and the Department should understand that the objective of an audit of statutory basis financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, policyholder surplus, as well as results of operations and cash flows in conformity with accounting practices prescribed or permitted by the Department. Consequently, under auditing standards generally accepted in the United States of America, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and

the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on statutory financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of KEMI to adopt sound accounting policies, to maintain an adequate and effective system of accounts and to establish and maintain an internal control that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of statutory basis financial statements in conformity with accounting practices prescribed or permitted by the Department.

The Department should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditors' report.

- d) We will retain the workpapers prepared in the conduct of our audit until the Department has filed a Report of Examination covering 2013, but no longer than seven years. After notification to KEMI, we will make the workpapers available for review by the Department at the offices of the insurer, at our office, at the Department or at any other reasonable place designated by the Department. Furthermore, in the conduct of the aforementioned periodic review by the Department, photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Department.
- e) The engagement partner has served in that capacity with respect to KEMI since 2013, is licensed by the Kentucky State Board of Accountancy and is a member in good standing of the American Institute of Certified Public Accountants.
- f) To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.

Dean Dotson Allen Ford, PLLC

March 28, 2014
Lexington, Kentucky

SUPPLEMENTARY INFORMATION

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement			
	1 Amount	2 Percentage	3 Amount	4 Securities Lending Reinvested Collateral Amount	5 Total (Col. 3 + 4) Amount	6 Percentage
1. Bonds:						
1.1 U.S. treasury securities.....	51,343,685	6.7	51,343,685		51,343,685	6.7
1.2 U.S. government agency obligations (excluding mortgage-backed securities):						
1.21 Issued by U.S. government agencies.....		0.0			0	0.0
1.22 Issued by U.S. government sponsored agencies.....	579,842	0.1	579,842		579,842	0.1
1.3 Non-U.S. government (including Canada, excluding mortgage-backed securities).....	3,986,962	0.5	3,986,962		3,986,962	0.5
1.4 Securities issued by states, territories and possessions and political subdivisions in the U.S.:						
1.41 States, territories and possessions general obligations.....	1,164,953	0.2	1,164,953		1,164,953	0.2
1.42 Political subdivisions of states, territories and possessions and political subdivisions general obligations.....	3,152,918	0.4	3,152,918		3,152,918	0.4
1.43 Revenue and assessment obligations.....	34,698,069	4.5	34,698,069		34,698,069	4.5
1.44 Industrial development and similar obligations.....		0.0			0	0.0
1.5 Mortgage-backed securities (includes residential and commercial MBS):						
1.51 Pass-through securities:						
1.511 Issued or guaranteed by GNMA.....	808,511	0.1	808,511		808,511	0.1
1.512 Issued or guaranteed by FNMA and FHLMC.....	107,475,967	14.0	107,475,967		107,475,967	14.0
1.513 All other.....		0.0			0	0.0
1.52 CMOs and REMICs:						
1.521 Issued or guaranteed by GNMA, FNMA, FHLMC or VA.....	23,675,583	3.1	23,675,583		23,675,583	3.1
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-based securities issued or guaranteed by agencies shown in Line 1.521.....		0.0			0	0.0
1.523 All other.....	87,922,407	11.4	87,922,407		87,922,407	11.4
2. Other debt and other fixed income securities (excluding short-term):						
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities).....	277,271,175	36.0	277,271,175		277,271,175	36.0
2.2 Unaffiliated non-U.S. securities (including Canada).....	74,514,410	9.7	74,514,410		74,514,410	9.7
2.3 Affiliated securities.....		0.0			0	0.0
3. Equity interests:						
3.1 Investments in mutual funds.....		0.0			0	0.0
3.2 Preferred stocks:						
3.21 Affiliated.....		0.0			0	0.0
3.22 Unaffiliated.....		0.0			0	0.0
3.3 Publicly traded equity securities (excluding preferred stocks):						
3.31 Affiliated.....		0.0			0	0.0
3.32 Unaffiliated.....	61,167,190	7.9	61,167,190		61,167,190	7.9
3.4 Other equity securities:						
3.41 Affiliated.....		0.0			0	0.0
3.42 Unaffiliated.....		0.0			0	0.0
3.5 Other equity interests including tangible personal property under lease:						
3.51 Affiliated.....		0.0			0	0.0
3.52 Unaffiliated.....		0.0			0	0.0
4. Mortgage loans:						
4.1 Construction and land development.....		0.0			0	0.0
4.2 Agricultural.....		0.0			0	0.0
4.3 Single family residential properties.....		0.0			0	0.0
4.4 Multifamily residential properties.....		0.0			0	0.0
4.5 Commercial loans.....		0.0			0	0.0
4.6 Mezzanine real estate loans.....		0.0			0	0.0
5. Real estate investments:						
5.1 Property occupied by company.....		0.0			0	0.0
5.2 Property held for production of income (including \$.....0 of property acquired in satisfaction of debt).....		0.0			0	0.0
5.3 Property held for sale (including \$.....0 property acquired in satisfaction of debt).....		0.0			0	0.0
6. Contract loans.....		0.0			0	0.0
7. Derivatives.....		0.0			0	0.0
8. Receivables for securities.....		0.0			0	0.0
9. Securities lending (Line 10, Asset Page reinvested collateral).....		0.0		XXX	XXX	XXX
10. Cash, cash equivalents and short-term investments.....	41,745,787	5.4	41,745,787		41,745,787	5.4
11. Other invested assets.....		0.0			0	0.0
12. Total invested assets.....	769,507,459	100.0	769,507,459	0	769,507,459	100.0

**SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES**

For the year ended December 31, 2013

(To be filed by April 1)

Of KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

Address (City, State, Zip Code): Lexington KY 40507-1724

NAIC Group Code.....0

NAIC Company Code.....10320

Employer's ID Number.....61-1275981

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on Page 2 of this annual statement. \$.....816,202,532

2. Ten largest exposures to a single issuer/borrower/investment.

	1	2	3	4
			Amount	Percentage of Total Admitted Assets
2.01 JPMorgan Chase & Co.....	Issuer	Description of Exposure	\$.....6,898,017	.....0.845 %
2.02 CenterPoint Energy Inc.....		Long-Term Bonds.....	\$.....6,228,383	.....0.763 %
2.03 General Electric Co.....		Long-Term Bonds & Common Stock.....	\$.....5,560,267	.....0.681 %
2.04 Citibank Credit Card Issuance Trust.....		Long-Term Bonds.....	\$.....5,073,845	.....0.622 %
2.05 Chase Issuance Trust.....		Long-Term Bonds.....	\$.....4,853,559	.....0.595 %
2.06 ConocoPhillips.....		Long-Term Bonds & Common Stock.....	\$.....4,594,718	.....0.563 %
2.07 Ford Motor Co.....		Long-Term Bonds & Common Stock.....	\$.....4,189,986	.....0.513 %
2.08 AT&T Inc.....		Long-Term Bonds & Common Stock.....	\$.....4,033,957	.....0.494 %
2.09 E.I. du Pont de Nemours & Co.....		Long-Term Bonds & Common Stock.....	\$.....3,865,550	.....0.474 %
2.10 Apple Inc.....		Long-Term Bonds & Common Stock.....	\$.....3,762,011	.....0.461 %

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC designation.

	1	2
<u>Bonds</u>		
3.01 NAIC-1.....	\$.....590,058,756	.....72.293 %
3.02 NAIC-2.....	\$.....108,866,544	.....13.338 %
3.03 NAIC-3.....	\$.....	.....0.000 %
3.04 NAIC-4.....	\$.....	.....0.000 %
3.05 NAIC-5.....	\$.....	.....0.000 %
3.06 NAIC-6.....	\$.....	.....0.000 %
<u>Preferred Stocks</u>		
3.07 P/RP-1.....	\$.....	.....0.000 %
3.08 P/RP-2.....	\$.....	.....0.000 %
3.09 P/RP-3.....	\$.....	.....0.000 %
3.10 P/RP-4.....	\$.....	.....0.000 %
3.11 P/RP-5.....	\$.....	.....0.000 %
3.12 P/RP-6.....	\$.....	.....0.000 %

4. Assets held in foreign investments:

4.01 Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?		Yes [] No [X]
If response to 4.01 above is yes, responses are not required for interrogatories 5-10.		
4.02 Total admitted assets held in foreign investments	\$.....72,589,832	.....8.894 %
4.03 Foreign-currency-denominated investments	\$.....	.....0.000 %
4.04 Insurance liabilities denominated in that same foreign currency	\$.....	.....0.000 %

5. Aggregate foreign investment exposure categorized by NAIC sovereign designation:

	1	2
5.01 Countries designated NAIC-1.....	\$.....67,514,399	.....8.272 %
5.02 Countries designated NAIC-2.....	\$.....5,075,433	.....0.622 %
5.03 Countries designated NAIC-3 or below.....	\$.....	.....0.000 %

6. Largest foreign investment exposures by country, categorized by the country's NAIC sovereign designation:

	1	2
Countries designated NAIC-1:		
6.01 Country 1: Australia.....	\$.....13,026,012	.....1.596 %
6.02 Country 2: United Kingdom.....	\$.....11,569,058	.....1.417 %
Countries designated NAIC-2:		
6.03 Country 1: Mexico.....	\$.....2,995,370	.....0.367 %
6.04 Country 2: Brazil.....	\$.....2,080,063	.....0.255 %
Countries designated NAIC-3 or below:		
6.05 Country 1: .....	\$.....	.....0.000 %
6.06 Country 2: .....	\$.....	.....0.000 %

7. Aggregate unhedged foreign currency exposure..... \$.....0.000 %

8.	Aggregate unhedged foreign currency exposure categorized by NAIC sovereign designation:	1	2
8.01	Countries designated NAIC-1.....	\$.....	.....0.000 %
8.02	Countries designated NAIC-2.....	\$.....	.....0.000 %
8.03	Countries designated NAIC-3 or below.....	\$.....	.....0.000 %
9.	Largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign designation:		
	Countries designated NAIC-1:	1	2
9.01	Country 1: .....	\$.....	.....0.000 %
9.02	Country 2: .....	\$.....	.....0.000 %
	Countries designated NAIC-2:		
9.03	Country 1: .....	\$.....	.....0.000 %
9.04	Country 2: .....	\$.....	.....0.000 %
	Countries designated NAIC-3 or below:		
9.05	Country 1: .....	\$.....	.....0.000 %
9.06	Country 2: .....	\$.....	.....0.000 %
10.	Ten largest non-sovereign (i.e. non-governmental) foreign issues:		
	1	2	
	<u>Issuer</u>	<u>NAIC Designation</u>	
			3 4
10.01	Shell International Fin.....	1.....	\$.....2,993,521 .....0.367 %
10.02	Petrobras Intl Fin Co.....	2.....	\$.....2,080,063 .....0.255 %
10.03	UBS AG Stamford Ct.....	1.....	\$.....2,013,644 .....0.247 %
10.04	TSMC Global Ltd.....	1.....	\$.....2,004,824 .....0.246 %
10.05	Total Capital Canada Ltd.....	1.....	\$.....2,002,784 .....0.245 %
10.06	Heineken NV.....	1.....	\$.....2,002,501 .....0.245 %
10.07	Govt of Bermuda.....	1.....	\$.....2,000,592 .....0.245 %
10.08	Novartis Capital Corp.....	1.....	\$.....1,999,951 .....0.245 %
10.09	Lloyds Bank PLC.....	1.....	\$.....1,999,783 .....0.245 %
10.10	Westpac Banking Corp.....	1.....	\$.....1,999,532 .....0.245 %
11.	Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure:		
11.01	Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets?		Yes [] No [X]
	If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11.		
11.02	Total admitted assets held in Canadian Investments.....	\$.....26,511,933	.....3.248 %
11.03	Canadian currency-denominated investments.....	\$.....	.....0.000 %
11.04	Canadian-denominated insurance liabilities.....	\$.....	.....0.000 %
11.05	Unhedged Canadian currency exposure.....	\$.....	.....0.000 %
12.	Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.		
12.01	Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets?		Yes [X] No []
	If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.		
	1	2	3
12.02	Aggregate statement value of investments with contractual sales restrictions.....	\$.....	.....0.000 %
	Largest three investments with contractual sales restrictions:		
12.03	.....	\$.....	.....0.000 %
12.04	.....	\$.....	.....0.000 %
12.05	.....	\$.....	.....0.000 %
13.	Amounts and percentages of admitted assets held in the ten largest equity interests:		
13.01	Are assets held in equity interest less than 2.5% of the reporting entity's total admitted assets?		Yes [] No [X]
	If response to 13.01 above is yes, responses are not required for the remainder of Interrogatory 13.		
	1	2	3
	<u>Name of Issuer</u>		
13.02	Lockheed Martin Corp.....	\$.....3,054,963	.....0.374 %
13.03	ConocoPhillips.....	\$.....2,557,883	.....0.313 %
13.04	Paychex Inc.....	\$.....2,500,052	.....0.306 %
13.05	Reynolds American Inc.....	\$.....2,155,569	.....0.264 %
13.06	Invesco Ltd.....	\$.....2,085,720	.....0.256 %
13.07	People's United Financial Inc.....	\$.....2,054,808	.....0.252 %
13.08	Altria Group Inc.....	\$.....1,789,742	.....0.219 %
13.09	CenturyLink Inc.....	\$.....1,542,941	.....0.189 %
13.10	Pfizer Inc.....	\$.....1,452,260	.....0.178 %
13.11	Johnson & Johnson.....	\$.....1,366,523	.....0.167 %
14.	Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:		
14.01	Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets?		Yes [X] No []
	If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.		
	1	2	3
14.02	Aggregate statement value of investments held in nonaffiliated, privately placed equities.....	\$.....	.....0.000 %
	Largest three investments held in nonaffiliated, privately placed equities:		
14.03	.....	\$.....	.....0.000 %
14.04	.....	\$.....	.....0.000 %
14.05	.....	\$.....	.....0.000 %

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:

15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 15.01 above is yes, responses are not required for the remainder of Interrogatory 15.

	1	2	3
15.02 Aggregate statement value of investments held in general partnership interests.....	\$.....		0.000 %
Largest three investments in general partnership interests:			
15.03	\$.....		0.000 %
15.04	\$.....		0.000 %
15.05	\$.....		0.000 %

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

	1	2	3
<u>Type (Residential, Commercial, Agricultural)</u>			
16.02	\$.....		0.000 %
16.03	\$.....		0.000 %
16.04	\$.....		0.000 %
16.05	\$.....		0.000 %
16.06	\$.....		0.000 %
16.07	\$.....		0.000 %
16.08	\$.....		0.000 %
16.09	\$.....		0.000 %
16.10	\$.....		0.000 %
16.11	\$.....		0.000 %

Amount and percentage of the reporting entity's total admitted assets held in the following categories of mortgage loans:

		<u>Loans</u>
16.12 Construction loans.....	\$.....	0.000 %
16.13 Mortgage loans over 90 days past due.....	\$.....	0.000 %
16.14 Mortgage loans in the process of foreclosure.....	\$.....	0.000 %
16.15 Mortgage loans foreclosed.....	\$.....	0.000 %
16.16 Restructured mortgage loans.....	\$.....	0.000 %

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

<u>Loan-to-Value</u>	<u>Residential</u>		<u>Commercial</u>		<u>Agricultural</u>	
	1	2	3	4	5	6
17.01 above 95%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.02 91% to 95%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.03 81% to 90%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.04 71% to 80%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.05 below 70%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

18.01 Are assets held in real estate reported less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

Largest five investments in any one parcel or group of contiguous parcels of real estate:

	1	2	3
<u>Description</u>			
18.02	\$.....		0.000 %
18.03	\$.....		0.000 %
18.04	\$.....		0.000 %
18.05	\$.....		0.000 %
18.06	\$.....		0.000 %

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans.

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the reporting entity's admitted assets?

Yes [X] No []

If response to 19.01 is yes, responses are not required for the remainder of Interrogatory 19.

	1	2	3
19.02 Aggregate statement value of investments held in mezzanine real estate loans.....	\$.....		0.000 %
Largest three investments held in mezzanine real estate loans:			
19.03	\$.....		0.000 %
19.04	\$.....		0.000 %
19.05	\$.....		0.000 %

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	<u>At Year-End</u>		<u>At End of Each Quarter</u>		
	1	2	<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>
			3	4	5
20.01 Securities lending agreements (do not include assets held as collateral for such transactions).....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.02 Repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.03 Reverse repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.04 Dollar repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.05 Dollar reverse repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps and floors:

	<u>Owned</u>		<u>Written</u>	
	1	2	3	4
21.01 Hedging.....	\$.....	.....0.000 %	\$.....	.....0.000 %
21.02 Income generation.....	\$.....	.....0.000 %	\$.....	.....0.000 %
21.03 Other.....	\$.....	.....0.000 %	\$.....	.....0.000 %

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

	<u>At Year-End</u>		<u>At End of Each Quarter</u>		
	1	2	1st Qtr 3	2nd Qtr 4	3rd Qtr 5
22.01 Hedging.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
22.02 Income generation.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
22.03 Replications.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
22.04 Other.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

	<u>At Year-End</u>		<u>At End of Each Quarter</u>		
	1	2	1st Qtr 3	2nd Qtr 4	3rd Qtr 5
23.01 Hedging.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
23.02 Income generation.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
23.03 Replications.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
23.04 Other.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....

**KENTUCKY EMPLOYERS' MUTUAL
INSURANCE AUTHORITY dba KENTUCKY
EMPLOYERS' MUTUAL INSURANCE
Statutory Basis Financial Statements and
Supplementary Information**

*Years Ended December 31, 2012 and 2011
with Report of Independent Auditors*

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DEAN || DORTON || ALLEN || FORD_{PC}**Report of Independent Auditors**

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI), which comprise the statements of admitted assets, liabilities and policyholder surplus - statutory basis as of December 31, 2012 and 2011, and the related statements of income and changes in policyholder surplus - statutory basis, and cash flows - statutory basis for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky. Management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Report of Independent Auditors, continued

Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles

As described in Note 2 of the financial statements, KEMI prepared these statutory basis financial statements using accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky, which is a basis of accounting other than accounting principles generally accepted in the United States of America, to meet the requirements of the Department of Insurance of the Commonwealth of Kentucky.

The effects on the financial statements of the variances between the statutory basis of accounting described in Note 2 and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the "Basis for Adverse Opinion on U.S. Generally Accepted Accounting Principles" paragraph, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States of America, the financial position of KEMI as of December 31, 2012 and 2011, or the results of its operations or its cash flows for the years then ended.

Opinion on Regulatory Basis of Accounting

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholder surplus of KEMI as of December 31, 2012 and 2011, and the results of its operations and its cash flows for the years then ended in accordance with the statutory basis of accounting prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky described in Note 2.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 - 9 be presented to supplement the basic statutory basis financial statements. Such information, although not a part of the basic statutory basis financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of the financial reporting for placing the basic statutory basis financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquires of management about methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic statutory basis financial statements, and other knowledge we obtained during our audit of the basic statutory basis financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Report of Independent Auditors, continued

Other Information

Our audits were conducted for the purpose of forming opinions on the financial statements that collectively comprise KEMI's basic statutory basis financial statements. The accompanying Summary Investment Schedule and Supplementary Investment Risks Interrogatories (Supplementary Information) are presented for purposes of additional analysis and are not a required part of the basic statutory basis financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the statutory basis financial statements. The effects on the Supplementary Information of the variances between the statutory accounting practices and accounting principles generally accepted in the United States of America are material and are described in Note 1. As a consequence, the Supplementary Information do not present fairly, in conformity with accounting principles generally accepted in the United States of America, such information of KEMI as of December 31, 2012 and for the year then ended. The Supplementary Information has been subjected to the auditing procedures applied in the audit of the statutory basis financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the statutory basis financial statements or to the statutory basis financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the Supplementary Information is fairly stated in all material respects in relation to the statutory basis financial statements taken as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated March 28, 2013 on our consideration of KEMI's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering KEMI's internal control over financial reporting and compliance.

Dean Dotson Allen Ford, PLLC

March 28, 2013
Lexington, Kentucky

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2012 MANAGEMENT'S DISCUSSION AND ANALYSIS

OBJECTIVE AND BACKGROUND

This discussion provides an assessment by management of the current financial position, results of operations, cash flow and liquidity of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI, or the Company). Information presented in this discussion supplements KEMI's 2012 audited statutory basis financial statements, as well as the schedules and exhibits included in KEMI's 2012 Annual Statement filed with the Department of Insurance of the Commonwealth of Kentucky.

KEMI is a unique entity in the Kentucky workers' compensation insurance marketplace. KEMI operates as a self-supporting, competitive state fund created for the purpose of providing both a market of last resort for employers in the Commonwealth, as well as furnishing another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage. KEMI performs its duties under authority granted directly to it by the Kentucky General Assembly. Except for items specifically addressed in its enabling statute, KEMI operates as a domestic mutual insurance company. KEMI began writing business effective September 1, 1995.

KEMI is governed by a ten member board of directors. Seven board members are appointed by the Governor and three board members are specified cabinet secretaries. The board is responsible for hiring a manager, and both the board and the manager are given specific statutory duties.

The Company has set about to apply fiscal responsibility to the administration of workers' compensation insurance by keeping the cost of coverage affordable to all employers in the Commonwealth through increased competition and superior service. In addition, the Company offers loss education programs and safety training to help policyholders control their own destiny in the marketplace. KEMI has no public funding and sets its standards based on long-term financial stability. KEMI does, in fact, make workers' comp work.

FINANCIAL POSITION

The Statement of Admitted Assets, Liabilities and Policyholder Surplus reflects KEMI's financial position at year end. KEMI's condensed Statements of Admitted Assets, Liabilities and Policyholder Surplus (balance sheets) as of December 31 were as follows:

	<u>2012</u>	<u>2011</u>
Admitted Assets:		
Long-term bonds and common stocks	\$ 688,582,443	\$ 644,607,564
Cash and short-term investments	14,425,190	25,116,986
Premium balances	38,915,059	33,737,094
Other assets	<u>5,961,404</u>	<u>6,030,766</u>
 Total assets	 <u>\$ 747,884,096</u>	 <u>\$ 709,492,410</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2012 MANAGEMENT'S DISCUSSION AND ANALYSIS

	<u>2012</u>	<u>2011</u>
Liabilities and Policyholder Surplus:		
Unpaid losses and loss adjustment expenses	\$ 497,657,521	\$ 476,585,556
Unearned premiums	59,286,900	54,219,111
Other liabilities	<u>17,846,362</u>	<u>19,099,968</u>
Total liabilities	574,790,783	549,904,635
Policyholder surplus	<u>173,093,313</u>	<u>159,587,775</u>
 Total liabilities and policyholder surplus	 \$ 747,884,096	 \$ 709,492,410

During 2012, KEMI's policyholder surplus increased by \$13,505,538. Items that positively affected surplus were net investment income of \$24,776,323, net realized capital gains of \$7,824,933, net unrealized capital gains of \$1,210,377, a decrease in non-admitted assets of \$3,249,223 and a decrease in the statutory provision for reinsurance of \$40,800. These positives were offset by a net underwriting loss of \$16,024,266, policyholder dividends of \$4,698,329 and non-admitted premium balances written off to bad debt expense of \$2,873,523 (net of \$187,708 in premium balances recovered and \$1,200 in fees for non-sufficient funds).

Assets

Net cash flows from operations amounted to \$25,989,955 in 2012. Net cash placed in the investment portfolio was \$36,361,269. The book value of KEMI's cash and invested assets grew by \$33,283,083, or 4.97%, as compared to 2011. Investment grade bonds are stated at amortized cost while non-investment grade bonds, if any, are stated at the lower of amortized cost or fair market value. At the end of 2012, the total book value of KEMI's long-term bonds was \$641,731,088. The bond portfolio had an effective duration of 5.37 years, an average book yield of 3.61% and an average credit rating of Aa3/A+. Common stocks, which are stated at fair market value as determined by the Securities Valuation Office of the NAIC, totaled \$46,851,355 and reflected a net unrealized gain of \$6,096,530 at the end of 2012. Cash and short-term investments, which are stated at fair market value, amounted to \$14,425,190. The total fair market value of KEMI's cash and invested assets was \$750,049,375.

Investments with unrealized losses are evaluated on a case by case basis to determine whether the decline in value might be permanent. When management deems a security to be permanently impaired, KEMI recognizes an Other Than Temporary Impairment (OTTI) realized loss on that security. During 2012, KEMI recognized OTTI losses of \$159,488 on certain common stocks whose market value had been less than 75% of cost basis for 12 consecutive months or more.

As a result of payment plan arrangements that KEMI offers to its policyholders, \$29,648,981 of the \$38,915,059 in premium balances reflected on the 2012 balance sheet were recorded, but the billings have been deferred and are not yet due. In addition, Statutory Accounting Principles require management to estimate the amount of premium that will be earned but unbilled at the end of each policy in force based upon past policy audit experience. Management's estimate of \$2,765,622 is included in KEMI's premium balances.

Non-admitted assets are those assets which, under Statutory Accounting Principles, must be excluded from the balance sheet by a direct charge to surplus. At the end of 2012 KEMI's non-admitted assets totaled \$4,358,615, down from \$7,607,838 at the end of 2011. The bulk of KEMI's non-admitted assets, or \$3,273,293, is comprised of

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2012 MANAGEMENT'S DISCUSSION AND ANALYSIS

premium balances that are more than 90 days past due or are otherwise determined to be uncollectible. The collectability of these receivables is regularly assessed and balances are written off to bad debt only after all efforts to secure payment have been exhausted. During 2012, previously non-admitted premium balances of \$3,062,431 were written off to bad debt expense. Other non-admitted assets consist of furniture, equipment and application software of \$182,236, prepaid expenses of \$335,000 and other receivables of \$568,086.

Liabilities

Reserves for unpaid losses and loss adjustment expenses are stated at the Company's estimate of the ultimate cost, net of ceded reinsurance, of settling all incurred but unpaid claims. Unpaid loss and loss adjustment expense reserves are based upon Company history and industry statistics, along with management's loss expectations based upon current premium levels. The method for making such estimates and for establishing the resulting liability is continually reviewed and any adjustments are reflected in the period determined. KEMI's reserves for unpaid losses and loss adjustment expenses are not discounted. Management believes that its loss reserving methodologies are conservative and that the Company's reserves are adequate. KEMI's reserves are evaluated annually by an independent third party actuary who provides a Statement of Actuarial Opinion to KEMI's independent auditors and to regulatory agencies. KEMI received an Unqualified Statement of Actuarial Opinion for 2012, as it has every year since its inception.

Activity with respect to losses and loss adjustment expenses, net of the effects of reinsurance, is displayed below:

	<u>2012</u>	<u>2011</u>
Unpaid losses and loss adjustment expenses, January 1	\$ 476,585,556	\$ 423,913,532
Losses incurred	85,091,428	93,352,921
Loss adjustment expenses incurred	<u>21,103,682</u>	<u>20,790,364</u>
Total incurred	<u>106,195,110</u>	<u>114,143,285</u>
Losses paid	65,877,780	43,137,257
Loss adjustment expenses paid	<u>19,245,365</u>	<u>18,334,004</u>
Total paid	<u>85,123,145</u>	<u>61,471,261</u>
Unpaid losses and loss adjustment expenses, December 31	\$ <u>497,657,521</u>	\$ <u>476,585,556</u>

Adjustments made to the loss and loss adjustment expense reserves of prior accident years resulted in a net decrease of \$5,824,582 in 2012 and a net increase of \$12,593,583 in 2011. In 2011, KEMI recorded a one-time charge of \$15 million to cover the anticipated impact of certain benefit provisions included in the Patient Protection and Affordable Care Act (PPACA). Better known as the Byrd Amendment, these benefit provisions restored a pre-1981 automatic entitlement wherein total disability from respiratory impairment is presumed to be the result of black lung, or pneumoconiosis, for any coal miner who worked for at least 15 years in underground mines or comparable surface mines. Eligible survivors of the affected miners are also automatically entitled to benefits. KEMI has been evaluating the impact of these claims as part of its rate setting and loss reserving methodologies since the PPACA was enacted.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2012 MANAGEMENT'S DISCUSSION AND ANALYSIS

Net losses and loss adjustment expenses paid in 2012 were \$23.7 million higher than those paid in 2011, primarily because 2011 included an offset of \$18.7 million related to the commutation of a quota share reinsurance contract which had been in effect for calendar year 2008.

At the end of 2012, KEMI had 4,888 open claims from direct business, consisting of 2,933 indemnity claims and 1,955 medical-only claims. KEMI also had 70 open claims from business assumed under the Company's multi-state program, which provides Kentucky-based policyholders with coverage for similar operations in other states.

Policyholder Surplus

KEMI's net financial position remained strong in 2012. Management regularly reviews premium levels, operating expenditures and investment performance to maintain the Company's sound financial footing. In addition, management monitors the Company's leverage position as it relates to premium and claim volumes compared to surplus levels. Looking forward, modest increases to surplus are expected, primarily from net investment income. As the economy continues to recover, the Company expects to see slight gains in direct written premiums due to increasing policyholder payrolls. Incurred losses, loss adjustment expenses and overall operating expenses are expected to remain relatively flat in 2013.

In 2012, KEMI's Board of Directors approved a dividend payable to 2009 policyholders who had a loss ratio of 75% or less. The dividend, which was calculated at 10% of earned premium for eligible policyholders, totaled \$6.3 million. KEMI's Board authorized management to apply \$1.6 million of the previous dividend that had not been disbursed due to policyholder ineligibility toward the dividend declared in 2012. KEMI's Board also authorized management to recover, from any dividend otherwise payable, past due premium amounts owed to KEMI on the date the dividend was issued. No dividend was declared in 2011.

RESULTS OF OPERATIONS

The Statement of Income measures the results of operations during the reporting period. KEMI's condensed Statements of Income for the years ended December 31 were as follows:

	<u>2012</u>	<u>2011</u>
Premiums earned	\$ 119,206,752	\$ 108,372,612
Losses and loss adjustment expenses incurred	106,195,110	114,143,285
Other underwriting expenses	<u>29,035,908</u>	<u>27,060,339</u>
Underwriting loss	(16,024,266)	(32,831,012)
Net investment income	24,776,323	26,732,636
Net realized capital gains	7,824,933	20,857,404
Other expenses	<u>(2,873,523)</u>	<u>(1,843,575)</u>
Net operating gain	13,703,467	12,915,453
Policyholder dividends	<u>(4,698,329)</u>	<u>0</u>
Net income after policyholder dividends	\$ <u>9,005,138</u>	\$ <u>12,915,453</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2012 MANAGEMENT'S DISCUSSION AND ANALYSIS

KEMI's direct written premiums were \$125,813,031 for 2012, reflecting a 10% increase from 2011. This increase is primarily attributed to the improving economy and the presence of larger workforces. KEMI has held overall rates flat in its last two rate filings effective October 1, 2012 and October 1, 2011. These rating actions exemplify KEMI's mission of making workers' compensation coverage affordable to employers by adhering to financially responsible underwriting practices.

CASH FLOW AND LIQUIDITY

Cash Flow

The Statement of Cash Flows reports cash provided and used by operations, investments, financing and miscellaneous activities during the reporting period. KEMI's condensed Statements of Cash Flows for the years ended December 31 were as follows:

	<u>2012</u>	<u>2011</u>
Cash Flows from Operations:		
Net cash from underwriting activities	\$ 9,203,849	\$ 28,642,751
Investment income received	26,210,114	28,370,856
Policyholder dividend payments	(6,550,485)	(461,922)
Other expenses	<u>(2,873,523)</u>	<u>(1,843,575)</u>
Net cash provided from operations	<u>25,989,955</u>	<u>54,708,110</u>
Cash Flows from Investments:		
Proceeds from investments sold or matured	235,882,906	300,964,645
Cost of investments acquired	<u>(272,244,175)</u>	<u>(324,346,633)</u>
Net cash used for investments	<u>(36,361,269)</u>	<u>(23,381,988)</u>
Cash Flows from Miscellaneous Activities:		
Other cash applied	<u>(320,482)</u>	<u>(19,818,841)</u>
Net cash used for miscellaneous activities	<u>(320,482)</u>	<u>(19,818,841)</u>
 Net change in cash and short-term investments	 (10,691,796)	 11,507,281
 Cash and short-term investments, beginning of year	 <u>25,116,986</u>	 <u>13,609,705</u>
 Cash and short-term investments, end of year	 <u>\$ 14,425,190</u>	 <u>\$ 25,116,986</u>

Liquidity

KEMI invests policyholder premiums in assets whose maturities closely match the actuarial expected payout of the related losses and loss adjustment expenses. Funds available for investment, which exceed the estimated amounts required to eventually satisfy liabilities, are primarily invested in long-term bonds. KEMI maintains a very liquid bond portfolio with an effective duration of 5.37 years, and KEMI's equity positions are all actively traded on major exchanges. KEMI has sufficient cash resources available to meet its liabilities as they come due.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2012 MANAGEMENT'S DISCUSSION AND ANALYSIS

NOTE: To the extent that the above comments constitute forward-looking statements, these statements are not guarantees of future performance. Forward-looking statements are based on current expectations and projections about future events and are subject to risks, uncertainties and assumptions about the Company, economic and market factors, judicial rulings and the insurance industry, among other things. Actual events and results may differ materially from those expressed in forward-looking statements.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Admitted Assets, Liabilities and Policyholder Surplus - Statutory Basis

December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Admitted Assets		
Long-term bonds	\$ 641,731,088	\$ 601,127,804
Common stock	46,851,355	43,479,760
Cash and short-term investments	14,425,190	25,116,986
Investment income due and accrued	5,474,584	5,500,203
Premiums in course of collection	9,266,078	6,628,043
Premiums booked but deferred and not yet due	29,648,981	27,109,051
Reinsurance receivable on losses and loss adjustment expenses	266,027	262,792
Electronic data processing equipment at cost, less accumulated depreciation of \$3,518,662 and \$3,397,665 in 2012 and 2011, respectively	<u>220,793</u>	<u>267,771</u>
Total admitted assets	\$ <u>747,884,096</u>	\$ <u>709,492,410</u>
Liabilities and Policyholder Surplus		
Unpaid losses	\$ 459,374,586	\$ 440,160,938
Unpaid loss adjustment expenses	38,282,935	36,424,618
Commissions payable	7,386,907	6,335,021
Unearned premiums	59,286,900	54,219,111
Amounts withheld or retained for others	6,378,382	6,351,952
Reinsurance premiums paid in advance	(763,126)	(608,753)
Remittances and items not allocated	923,239	949,784
Policyholder dividend payable	37,058	1,889,214
Other liabilities	<u>3,883,902</u>	<u>4,182,750</u>
Total liabilities	574,790,783	549,904,635
Policyholder surplus	<u>173,093,313</u>	<u>159,587,775</u>
Total liabilities and policyholder surplus	\$ <u>747,884,096</u>	\$ <u>709,492,410</u>

See accompanying notes.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Statements of Income - Statutory Basis

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Premiums earned:		
Direct	\$ 120,742,275	\$ 110,817,105
Assumed	4,138,145	2,371,745
Ceded	<u>(5,673,668)</u>	<u>(4,816,238)</u>
	119,206,752	108,372,612
Losses incurred:		
Direct	73,678,541	95,935,718
Assumed	2,071,716	1,388,724
Ceded	<u>9,341,171</u>	<u>(3,971,521)</u>
	85,091,428	93,352,921
Loss adjustment expenses, net of ceded	21,103,682	20,790,364
Commissions and brokerage fees	14,889,434	13,924,615
Other underwriting expenses	<u>14,146,474</u>	<u>13,135,724</u>
Total underwriting expenses	<u>135,231,018</u>	<u>141,203,624</u>
Net underwriting loss	(16,024,266)	(32,831,012)
Investment income, net of investment expenses of \$1,636,110 and \$1,452,414 in 2012 and 2011, respectively	24,776,323	26,732,636
Net realized capital gains	7,824,933	20,857,404
Bad debt and other expenses	<u>(2,873,523)</u>	<u>(1,843,575)</u>
Net income before policyholder dividend	13,703,467	12,915,453
Policyholder dividend	<u>4,698,329</u>	<u>-</u>
Net income	<u>\$ 9,005,138</u>	<u>\$ 12,915,453</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Statements of Changes in Policyholder Surplus - Statutory Basis

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Policyholder surplus, beginning of year	\$ 159,587,775	\$ 143,680,297
Net income	9,005,138	12,915,453
Change in net unrealized gains on investments	1,210,377	666,190
Change in non-admitted assets	3,249,223	2,363,147
Change in provision for reinsurance	<u>40,800</u>	<u>(37,312)</u>
Policyholder surplus, end of year	\$ <u>173,093,313</u>	\$ <u>159,587,775</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Statements of Cash Flows - Statutory Basis

Years ended December 31, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Premiums collected, net of reinsurance	\$ 122,028,481	\$ 113,834,536
Investment income, net of investment expenses	26,210,114	28,370,856
Miscellaneous expenses	(2,873,523)	(1,843,575)
Benefit and loss related payments	(65,881,016)	(43,072,300)
Commissions, expenses paid and aggregate write-ins	(46,943,616)	(42,119,485)
Dividend paid to policyholders	<u>(6,550,485)</u>	<u>(461,922)</u>
Net cash provided by operating activities	25,989,955	54,708,110
Cash flows from investing activities:		
Proceeds from investments sold or matured	235,882,906	300,964,645
Cost of investments acquired	<u>(272,244,175)</u>	<u>(324,346,633)</u>
Net cash used in investing activities	(36,361,269)	(23,381,988)
Cash flows from miscellaneous activities:		
Other cash applied	<u>(320,482)</u>	<u>(19,818,841)</u>
Net change in cash and short-term investments	(10,691,796)	11,507,281
Cash and short-term investments, beginning of year	<u>25,116,986</u>	<u>13,609,705</u>
Cash and short-term investments, end of year	\$ <u>14,425,190</u>	\$ <u>25,116,986</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements

1. Description of Organization

Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) is a non-profit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). KEMI was established by legislation of the Commonwealth enacted April 4, 1994 to serve as a competitive state fund for the purpose of providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage as required by state law. KEMI began writing business effective September 1, 1995.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying statutory basis financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky (the Department). The Department recognizes only statutory accounting practices prescribed or permitted by the Commonwealth of Kentucky for determining solvency under the Kentucky Insurance law. The National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual* has been adopted as a component of prescribed or permitted practices by the Commonwealth of Kentucky. The Department has the right to permit other specific practices that deviate from the prescribed practices. However, KEMI does not employ any such practices.

These statutory accounting practices comprise a comprehensive basis of accounting other than accounting practices generally accepted in the United States of America (GAAP) and differ in some respects. Some of the more significant of these differences are as follows:

- a. Investments in bonds with an NAIC rating of 1 or 2 are carried at NAIC determined value or amortized cost, whereas bonds with a NAIC rating of 3 through 6 are assigned specific year-end values by the NAIC and are written down to Securities Valuation Office (SVO) assigned values (if less than amortized cost) by charging statutory policyholder surplus. Under GAAP, bonds are classified into three categories: held to maturity, available for sale, and trading. Bonds held to maturity are stated at amortized cost; bonds available for sale are stated at fair value and the resulting unrealized gains or losses, net of applicable income taxes, are charged or credited to policyholder surplus; and bonds held for trading are reported at fair value and the resulting unrealized gains and losses are reported in earnings, net of related taxes.

The fair value of investments on a statutory basis is determined by the SVO, whereas for GAAP, the fair value of investments is determined based on the expected exit price.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

For loan-backed and structured securities, if the company determines that a security is impaired and they intend to sell the security or no longer have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security shall be written down to fair value. For statutory purposes, if the company subsequently changes their assertion, and now believe they do not intend to sell the security and have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security will continue to be carried at the lower of cost or market with any future decreases in fair value charged through operations until the security is disposed. For GAAP purposes, once the company alters their assertion, that security's amortized cost basis will not be decreased for future reductions in fair value unless an other than temporary impairment is determined to have occurred.

Also, for GAAP purposes, other-than-temporary impairment losses (related to non loan-backed and structured securities) related to debt securities are bifurcated between credit and non-credit, where for statutory purposes the total other-than-temporary impairment loss is reported in earnings.

b. Assets having economic value other than those that can be used to fulfill policyholder obligations are categorized as "nonadmitted assets" and are not permitted to be included in the statutory financial statements of admitted assets, liabilities, and policyholder surplus, whereas, for GAAP, these assets are recognized in the balance sheet. Included with nonadmitted assets are furniture, equipment and supplies, prepaid expenses, certain receivables and other items that do not meet statutory criteria for admitted assets.

c. Receivables over 90 days outstanding are not admitted to the statutory financial statements and charged to policyholder surplus, whereas, for GAAP, the company assesses the collectability of premiums receivable and any charge is to the income statement.

d. The statutory financial statements are presented net of the effects of reinsurance, whereas, for GAAP, the financial statements are presented gross of the effects of reinsurance.

e. Guaranty fund assessments are generally available for recoupment from policyholders and as such, amounts assessed are recorded as a recoverable asset. Under GAAP, these assessments against the company are expensed when incurred and subsequently recorded as revenue when collected from the policyholders. Assessments against the policyholders are shown as a liability.

f. Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and, to the extent recoverable, amortized with deferred policy acquisition costs, as required under GAAP.

g. Comprehensive income is not determined for statutory reporting purposes, whereas, for GAAP, such income is recognized.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

h. Costs incurred in connection with acquiring new insurance business, including commissions, are charged against statutory earnings as such costs are incurred, while, under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective periods covered by the related policies.

i. A statutory liability has been established and charged to policyholder surplus for amounts due from unauthorized reinsurers in excess of letters of credit, funds held, and premiums payable. Under GAAP, no such liability is provided.

j. The statutory statement of cash flows differs in certain respects from the presentation required within GAAP literature, including the presentation of changes in cash and short-term investments instead of cash and cash equivalents.

k. The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements that KEMI files with the NAIC and the state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP reporting.

The effect of the differences between statutory accounting practices and accounting principles generally accepted in the United States of America has not been determined, but is presumed to be material.

Risks and Uncertainties

Certain risks and uncertainties are inherent to KEMI's day-to-day operations and to the process of preparing its statutory basis financial statements. The more significant of those risks and uncertainties are presented below and throughout the notes to the statutory basis financial statements.

Use of Estimates - The preparation of the statutory basis financial statements requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statutory basis financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of unpaid losses and loss adjustment expenses. In connection with the determination of this liability, management uses the methodology described in *Unpaid Losses and Loss Adjustment Expenses* later in this footnote. While management uses the best information available to estimate unpaid losses and loss adjustment expenses, future changes to the liability may be necessary based on claims experience and changing claims frequency and severity conditions, as well as changes in doctrines of legal liability and damage awards in Kentucky. The future changes will be charged or credited to expense when they occur.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Loss Reserves - KEMI estimates losses and loss adjustment expenses (LAE) based on the accumulation of case estimates and loss reports, as well as estimates of incurred but not reported (IBNR) losses, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported and unreported claims and incidents. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Actual results could differ from these estimates.

Reinsurance - Reinsurance contracts do not relieve KEMI from its obligations to insureds. Failure of reinsurers to honor their obligations could result in losses to KEMI. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Management believes that any liability arising from this contingency would not be material to KEMI's financial position.

Investment Risk - KEMI is exposed to risks that issuers of securities owned by KEMI will default or that interest rates will change and cause a decrease in the value of its investments. With mortgage-backed securities, KEMI is exposed to credit risk and prepayment risk.

As interest rates decline, the velocity at which these securities pay down the principal will increase. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

KEMI maintains balances at financial institutions that may exceed federally insured limits; however, it also utilizes repurchase agreements and money market funds to mitigate this risk. KEMI's management continually evaluates the financial stability of these financial institutions, and does not believe they are exposed to unnecessary risk.

Since most of KEMI's investments consist of securities that are traded in the public securities markets, they are subject to risk related to fluctuations in overall market performance and are potentially subject to heightened levels of market risk attributable to issuer, industry, and geographic region concentrations. KEMI's investment portfolio is regularly reviewed and the extent of its diversification is considered in the context of statutory requirements and other risk management and performance objectives.

External Factors - KEMI is highly regulated by the state in which it is domiciled. Such regulations, among other things, limit the amount of dividends and impose restrictions on the amount and types of investments. In addition, from time to time, KEMI may be affected by changes in federal regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), or the Patient Protection and Affordable Care Act (PPACA). Additionally, the PPACA contained an amendment with specific language related to black lung claims (the Byrd Amendment). KEMI continues to monitor the impact of such regulations and will assess any potential impact of these changes.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Risk-Based Capital - The NAIC has developed property-casualty risk-based capital (RBC) standards that relate an insurer's reported statutory capital and policyholder surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to protect KEMI from the various risks that it faces. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. KEMI continues to monitor its internal capital requirements and the NAIC's RBC requirements. KEMI has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that KEMI's capital levels are sufficient to support the level of risk inherent in its operations.

Investments

Investments, excluding residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies, are stated at values prescribed by the NAIC's Security Valuation Office (SVO), which generally are as follows:

Non loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method with bonds containing call provisions being amortized to the call or maturity date, whichever results in a lower asset value. Loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method including anticipated prepayments. Bonds rated 3 through 6 are carried at fair value with the change run through policyholder surplus.

Investments in residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies utilize a financial model commissioned by the NAIC to determine credits ratings, and ultimately the NAIC designation/rating. This financial model requires a two step process. KEMI first determines the initial rating designation based upon each security's amortized cost in relation to security specific prescribed break points. This initial rating designation determines whether the security will be stated at amortized cost or fair value, based on the same criteria noted in the preceding paragraph. (The lower the amortized cost relative to par, the higher the NAIC designation, and the more likely the security will be carried at amortized cost.) If the security is to be carried at fair value, KEMI then determines the final rating designation based upon each security's fair value in relation to the same security specific prescribed break points used in the first step. If the security is to be carried at amortized cost, the final designation remains the same as what was determined in the first step. The final designation is used for RBC purposes as well as for NAIC designation disclosure purposes.

Investments in preferred stocks with an NAIC rating designation of 1 or 2 are stated at amortized cost; all other preferred stocks are stated at the lesser of amortized cost or fair value.

Investments in common stocks are stated at fair value with unrealized gains and losses being reported as a separate component of unassigned policyholder surplus.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Investments, continued

Realized gains or losses are determined on the specific-identification method. Investment income is recognized as earned, net of related investment expenses. Bond premiums and discounts are amortized by the scientific-yield method and are charged or credited to net investment income. For mortgage-backed securities, KEMI anticipates prepayments utilizing published data in applying interest income.

The assessment of other-than-temporary impairments is performed on a case-by-case basis. Factors considered by management in determining whether an other-than-temporary impairment exists (in other than loan-backed or structured securities) include: the financial condition, business prospects and creditworthiness of the issuer, the length of time and extent to which fair value has been less than cost for equity securities or amortized cost for fixed income securities, and KEMI's intent and ability to retain such investments until the fair value recovers. If it is determined that the decline in fair market value is other than temporary, the carrying amount of the investment is written down to fair value as its new basis and the amount of the write-down is recorded as a realized loss.

For loan-backed or structured securities, factors considered by management in determining whether an other-than-temporary impairment exists include: KEMI's stated intent to not sell, KEMI's ability to hold such investments until the fair value recovers, and the discounted cash flows of the security based on the yield at the date of acquisition. If KEMI intends to sell or if KEMI does not have the ability and intent to hold the security for a period of time sufficient to recover its amortized cost basis, an other-than-temporary impairment exists, and the security is written down to fair value with the amount of the write-down recorded as a realized loss. If KEMI does not intend to sell the security and has the ability and intent to hold the security for a period of time sufficient to recover the amortized cost basis, KEMI calculates the cash flows expected to be collected. In this calculation, KEMI compares the present value of cash flows expected to be collected, discounted at the security's effective interest rate at date of purchase, to the amortized cost basis. If the present value of cash flows is less than the amortized cost basis, a realized loss is recorded for the difference. The present value of cash flows then becomes the new cost basis.

KEMI uses the prospective method to accrete the amortized cost basis to the ultimate expected cash flows.

Premiums

Premiums are earned on the daily pro-rata method over the policy period and are stated after deduction for reinsurance. Unearned premiums represent the portion of initial premiums written that are applicable to the unexpired terms of policies in force. Initial premiums are recorded as premiums written on the policy effective date except for certain premiums that are recorded on an installment basis. Any subsequent additional premiums or refunds that occur as a result of policy audits are recorded as written premiums at the time the policy audits are finalized. Earned but unbilled premiums represent management's estimate of future audit premiums and are included in premiums booked but deferred and not yet due.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Premiums, continued

Premiums in course of collection which are customer obligations due under normal terms requiring payment by the policy due date, and premiums booked but deferred and not yet due are valued at their carrying amount, which approximates fair value. Receivables over 90 days outstanding are not admitted to the statutory basis financial statements.

Unpaid Losses and Loss Adjustment Expenses

The estimated liability for losses is based on the accumulation of case estimates for claims and incidents reported, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported claims and incidents. Also included in the liability are estimates of incurred but not reported losses based on historical experience adjusted for current trends. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Estimates for loss and related LAE are made without regard to the time value of money.

Management believes that the provisions for losses and LAE are adequate to cover the net cost of claims incurred and incidents reported; however, the provisions are necessarily based upon estimates and, therefore, the ultimate liability may be less than or exceed such estimates. As adjustments become necessary in these estimates, such adjustments are reflected in the results of operations in the period in which they are determined.

The reserves for unpaid losses are net of anticipated subrogation.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums, losses, and loss adjustment expenses are reported net of reinsured amounts. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. KEMI holds funds and collateral as security under reinsurance agreements in the form of letters of credit for any reinsurers not subject to the regulation of the Kentucky Commissioner of Insurance. In the opinion of management, all amounts due from reinsurers at December 31, 2012 and 2011 are recoverable.

Cash and Short-Term Investments

Cash and short-term investments consist of cash on deposit with financial institutions and investments with original maturities of less than one year at the date of acquisition. These investments are carried at cost, which approximates fair value.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Concentrations of Geographic and Credit Risk

All of KEMI's total direct gross written premiums of \$125,813,031 for the year ended December 31, 2012 were for insureds in Kentucky.

The credit quality of the bond portfolio at December 31, 2012 is presented as follows:

	<u>Carrying Value</u>	<u>Percentage</u>
Class 1 - highest quality	\$ 542,425,401	84.5 %
Class 2 - high quality	<u>99,305,687</u>	<u>15.5</u>
Total	\$ <u>641,731,088</u>	<u>100 %</u>

Bonds with ratings from AAA to BBB as assigned by Standard & Poor's Corporation are generally considered as investment grade securities. Some securities issued by the U.S. government or an agency thereof are not rated but are considered to be investment grade. The NAIC regards U.S. Treasuries and agencies and all A ratings as Class 1 (highest quality), BBB ratings as Class 2 (high quality), BB ratings as Class 3 (medium quality), B ratings as Class 4 (low quality), C ratings as Class 5 (lower quality), and D ratings as Class 6 (in or near default).

Property and Equipment

Electronic data processing equipment, including operating software, is stated at cost less accumulated depreciation. Depreciation expense on such property was \$252,677 and \$242,696 in 2012 and 2011, respectively. Furniture, office equipment, and application software are non-admitted assets under statutory accounting practices. Depreciation expense on such property was \$277,612 and \$395,811 in 2012 and 2011, respectively.

Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. Gains and losses on the sale of property and equipment are recorded in the year of disposition. Maintenance and repairs are expensed as incurred; replacements and betterments are capitalized.

Advertising

KEMI expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2012 and 2011, was \$1,072,523 and \$790,488, respectively.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Subsequent Events

All of the effects of subsequent events that provide additional evidence about conditions that existed at the statement of admitted assets, liabilities and policyholder surplus date, including the estimates inherent in the process of preparing the statutory basis financial statements, are recognized in the statutory basis financial statements. KEMI does not recognize subsequent events that provide evidence about conditions that did not exist at the statement of admitted assets, liabilities and policyholder surplus date but arose after, but before the statutory basis financial statements are available to be issued. In some cases, nonrecognized subsequent events are disclosed to keep the statutory basis financial statements from being misleading.

Management has evaluated subsequent events for accounting and disclosure requirements through March 28, 2013, the date that the statutory basis financial statements were available to be issued. There were no events occurring during the evaluation period that require recognition or disclosure in the statutory basis financial statements.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

3. Investments

Long-Term Bonds

The statement value, gross unrealized gains, gross unrealized losses, and the estimated fair value of investments in bonds are summarized as follows:

	Statement Value	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
As of December 31, 2012:				
U.S. government	\$ 56,549,130	\$ 1,596,177	\$ (64,106)	\$ 58,081,201
U.S. special revenue	155,544,786	10,296,642	(100,125)	165,741,303
State government	2,164,854	98,806	-	2,263,660
All other governments	1,985,002	309,998	-	2,295,000
Political subdivisions	3,160,508	355,372	-	3,515,880
Corporate securities	<u>422,326,808</u>	<u>34,709,892</u>	<u>(160,914)</u>	<u>456,875,786</u>
	<u>\$ 641,731,088</u>	<u>\$ 47,366,887</u>	<u>\$ (325,145)</u>	<u>\$ 688,772,830</u>
As of December 31, 2011:				
U.S. government	\$ 74,955,081	\$ 3,630,830	\$ -	\$ 78,585,911
U.S. special revenue	148,465,949	8,243,364	(70,377)	156,638,936
State government	2,164,622	71,424	-	2,236,046
All other governments	2,646,129	121,052	-	2,767,181
Political subdivisions	3,167,785	142,215	-	3,310,000
Corporate securities	<u>369,728,238</u>	<u>25,142,252</u>	<u>(856,918)</u>	<u>394,013,572</u>
	<u>\$ 601,127,804</u>	<u>\$ 37,351,137</u>	<u>\$ (927,295)</u>	<u>\$ 637,551,646</u>

The carrying value and estimated fair value of bonds at December 31, 2012 and 2011, by contractual maturity, are as follows. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Statement Value	Estimated Fair Value
Less than one year	\$ 11,011,679	\$ 11,242,480
One year through five years	219,767,186	235,601,383
Six years through ten years	224,863,203	242,791,165
After ten years	<u>186,089,020</u>	<u>199,137,802</u>
	<u>\$ 641,731,088</u>	<u>\$ 688,772,830</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Long-Term Bonds, continued

Proceeds from sales and maturities of bonds during 2012 and 2011 were \$209,465,423 and \$289,814,808, respectively. Gross gains of \$6,292,820 and \$21,601,354, and gross losses of \$208,873 and \$997,141 were realized on those sales in 2012 and 2011, respectively.

Common Stocks

Gross unrealized capital gains and losses on common stocks are included in policyholder surplus as follows:

	<u>2012</u>	<u>2011</u>
Cost	\$ 40,754,825	\$ 38,593,607
Gross unrealized capital gains	7,236,117	6,829,391
Gross unrealized capital losses	<u>(1,139,587)</u>	<u>(1,943,238)</u>
Net unrealized capital gain	<u>6,096,530</u>	<u>4,886,153</u>
Fair value	<u>\$ 46,851,355</u>	<u>\$ 43,479,760</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment

The following table illustrates the gross unrealized losses and fair value of investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment type and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2012 and 2011:

	December 31, 2012					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. government	\$ 8,476,015	\$ (64,106)	\$ -	\$ -	\$ 8,476,015	\$ (64,106)
Agency mortgage-backed	5,878,591	(69,644)	1,882,179	(30,481)	7,760,770	(100,125)
Commercial asset-backed	151,398	(1,033)	-	-	151,398	(1,033)
Other corporate bonds	20,471,065	(159,881)	-	-	20,471,065	(159,881)
Equity securities	<u>10,199,214</u>	<u>(815,301)</u>	<u>1,206,138</u>	<u>(324,286)</u>	<u>11,405,352</u>	<u>(1,139,587)</u>
Total	<u>\$ 45,176,283</u>	<u>\$ (1,109,965)</u>	<u>\$ 3,088,317</u>	<u>\$ (354,767)</u>	<u>\$ 48,264,600</u>	<u>\$ (1,464,732)</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

	December 31, 2011					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Agency mortgage-backed	\$ 4,450,290	\$ (70,377)	\$ -	\$ -	\$ 4,450,290	\$ (70,377)
Commercial mortgage-backed	274,952	(51)	-	-	274,952	(51)
Commercial asset-backed	3,358,692	(52,312)	1,207,213	(96,942)	4,565,905	(149,254)
Other corporate bonds	20,556,765	(691,407)	987,420	(16,206)	21,544,185	(707,613)
Equity securities	6,366,893	(776,493)	2,516,785	(1,166,745)	8,883,678	(1,943,238)
Total	\$ 35,007,592	\$ (1,590,640)	\$ 4,711,418	\$ (1,279,893)	\$ 39,719,010	\$ (2,870,533)

KEMI evaluates impairment at each reporting period for each of the securities (other than loan-backed or structured securities) whereby the fair value of the investment is less than its amortized cost. It is expected that the securities would not be settled at a price less than the amortized cost of the investment, as KEMI has the ability and intent to hold the investment until there is not an unrealized loss on the investment. KEMI evaluated the credit ratings of these holdings, noting neither a significant deterioration since purchase nor other factors which may indicate an other-than-temporary impairment, such as the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and KEMI's intent and ability to hold the investment for a sufficient time in order to enable recovery of cost. KEMI continually monitors risk related to sub-prime investments. The current impact on the portfolio of sub-prime investments is minimal.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

KEMI's third party investment manager evaluated each loan-backed and structured security for impairment where the fair value of the investment was less than its amortized cost. For those securities that KEMI does intend to sell or does not have the ability to hold the security until recovery, an impairment is recorded equal to the difference of amortized cost and fair value. For all other loan-backed and structured securities, KEMI's asset manager used a proprietary model for loss assumptions and widely accepted models for prepayment assumptions in valuing mortgage-backed and asset-backed securities with inputs from major third party data providers. It combined the effects of interest rates, volatility, and prepayment speeds based on Monte Carlo simulation with credit loss analysis and resulting effective analytics (spreads, duration, convexity). Model assumptions were specific to asset class and collateral types and were regularly evaluated and adjusted where appropriate.

In 2012, KEMI permanently impaired several common stocks that had been in a continuous unrealized loss position for more than twelve months. Accordingly, the cost basis of these stocks was written down and previously unrealized losses of \$159,488 were recharacterized to realized losses.

KEMI continues to review its investment portfolio under its impairment review policy. Given the fluctuating market conditions and the significant judgment involved, there is a continuing risk that further declines in fair value may occur and additional other than temporary impairments may be recorded in future periods.

4. Fair Value Measurements

The following table presents the carrying value and estimated fair value of KEMI's significant financial instruments at December 31, 2012 and 2011:

	<u>2012</u>		<u>2011</u>	
	<u>Statement</u>	<u>Estimated</u>	<u>Statement</u>	<u>Estimated</u>
	<u>Value</u>	<u>Fair Value</u>	<u>Value</u>	<u>Fair Value</u>
Cash and short-term investments	\$ 14,425,190	\$ 14,425,190	\$ 25,116,986	\$ 25,116,986
U.S. government securities	52,251,771	53,608,120	41,687,740	43,179,575
U.S. agency mortgage-backed securities	4,297,359	4,473,081	33,267,341	35,406,336
U.S. special revenue bonds	155,544,786	165,741,303	148,465,949	156,638,936
Commercial mortgage-backed securities	40,291,337	43,216,999	31,966,678	33,623,301
Commercial asset-backed securities	41,421,945	42,429,745	34,844,125	35,837,748
Other corporate bonds	340,613,526	371,229,042	302,917,435	324,552,523
All other bonds	7,310,364	8,074,540	7,978,536	8,313,227
Equity securities	<u>46,851,355</u>	<u>46,851,355</u>	<u>43,479,760</u>	<u>43,479,760</u>
Total	<u>\$ 703,007,633</u>	<u>\$ 750,049,375</u>	<u>\$ 669,724,550</u>	<u>\$ 706,148,392</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE

Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2012 and 2011. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these statutory financial statements since that date, and current estimates of fair value may differ significantly from the amounts presented herein.

The following methods and assumptions were used to estimate the fair value of each significant class of financial instruments for which it is practical to estimate that value:

Cash and short-term investments: Valued at cost. The carrying amounts reported in the statements of admitted assets, liabilities and policyholder surplus approximate their fair value due to their short maturity.

Bonds, loan-backed and structured securities, and common stocks: Valued at fair value by the market and a third party portfolio manager. Fair values are based on values published by the SVO, quoted market prices, or dealer quotes. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services, or in the case of private placements, are estimated by discounting the expected future cash flows using current market rates applicable to the yield, credit, and maturity of the investment.

KEMI's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to fair values determined using unadjusted quote prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to fair values determined using unobservable inputs (Level 3). An asset's or liability's classification is determined based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that KEMI has the ability to access at the measurement date.

Level 2 – Valuations derived from inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as:

- a) Quoted prices for similar assets or liabilities in active markets.
- b) Quoted prices for identical or similar assets or liabilities in markets that are not active.
- c) Inputs other than quoted prices that are observable for the asset or liability.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Valuations are derived from techniques that require significant unobservable inputs. The unobservable inputs reflect KEMI's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

KEMI holds common stocks that are measured at fair value on a recurring basis. In addition, KEMI sometimes holds certain financial assets, primarily certain bonds valued at the lower of cost or fair value in accordance with NAIC reporting guidelines and assets that are impaired during the current reporting period and carried at fair value, that are considered to be measured at fair value on a recurring basis. The following table summarizes KEMI's assets and liabilities measured at fair value on a recurring basis as follows:

	Fair Value Measurements at Reporting Date Using			
	Fair Value	Level 1	Level 2	Level 3
December 31, 2012				
Investments:				
Common stock	\$ 46,851,355	\$ 46,851,355	\$ -	\$ -

	Fair Value Measurements at Reporting Date Using			
	Fair Value	Level 1	Level 2	Level 3
December 31, 2011				
Investments:				
Common stock	\$ 43,479,760	\$ 43,479,760	\$ -	\$ -

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

5. Losses and Loss Adjustment Expenses

As of December 31, 2012 and 2011, the following table provides a reconciliation of the beginning and ending reserve balances for losses and loss adjustment expenses (LAE):

	<u>2012</u>	<u>2011</u>
Gross reserves for losses and LAE - beginning of year	\$ 538,700,239	\$ 501,761,330
Less reinsurance recoverables	<u>62,114,683</u>	<u>77,847,798</u>
Net reserves for losses and LAE - beginning of year	476,585,556	423,913,532
Provision for claims, related to:		
Current year	112,019,692	101,549,702
Prior years	<u>(5,824,582)</u>	<u>12,593,583</u>
Total incurred	106,195,110	114,143,285
Payments for claims, related to:		
Current year	(34,556,637)	(30,851,843)
Prior years	<u>(50,566,508)</u>	<u>(30,619,418)</u>
Total paid	<u>(85,123,145)</u>	<u>(61,471,261)</u>
Net reserves for losses and LAE - end of year	497,657,521	476,585,556
Plus reinsurance recoverables	<u>51,988,383</u>	<u>62,114,683</u>
Gross reserves for losses and LAE - end of year	\$ <u>549,645,904</u>	\$ <u>538,700,239</u>

As a result of changes in estimates of insured events in prior years, the liability for unpaid losses and loss adjustment expenses (net of reinsurance recoverables) (decreased) increased by \$(5,824,582) and \$12,593,583 in 2012 and 2011, respectively. Anticipated subrogation recoverable on unpaid losses was \$3,500,000 as of December 31, 2012 and 2011.

KEMI's objective is to establish reported and unreported loss reserves that are adequate to cover all loss costs, while sustaining minimal variation from the date that the reserves are initially established until losses are fully developed. KEMI's prior year reserves developed unfavorably in 2011. In 2011, the development primarily related to recording of reserves related to the Byrd Amendment, which stemmed from the PPACA.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance

KEMI limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with various reinsurers under excess of loss and quota share agreements. These agreements cede premium on an earned basis. Ceded reinsurance is treated as the risk and liability of the assuming companies; however, these reinsurance contracts do not relieve KEMI from its original obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to KEMI; consequently, allowances are established for amounts deemed uncollectible. KEMI evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

KEMI maintains Excess of Loss reinsurance coverage with unaffiliated reinsurers for losses and loss adjustment expenses in excess of \$2 million per occurrence and up to \$75 million per occurrence. The Excess of Loss reinsurance agreements apply to KEMI's net retained liability, covering direct and assumed business in force as of each effective date, as well as business new or renewed from the effective date through the end of the contract term. Unpaid losses and loss adjustment expenses as of December 31, 2012 and 2011 included estimated reinsurance recoverables under the Excess of Loss agreements of \$51,988,383 and \$62,114,683, respectively.

Effective September 1, 2012, KEMI obtained Terrorism Excess of Loss reinsurance through Lloyd's of London. This reinsurance covers the following for qualifying events: 100% coverage of \$7 million per occurrence in excess of \$16 million, and 15% coverage of \$127 million per occurrence in excess of \$23 million. For non-qualifying events, this reinsurance covers 100% of \$84 million per occurrence in excess of \$16 million. In no event shall the amount of net loss exceed \$84 million.

On January 1, 2011, KEMI commuted its quota share reinsurance agreements with unaffiliated reinsurers which were in effect for 2008 policies. KEMI increased its loss and loss adjustment expense reserves and reduced the related funds withheld balance by \$18,669,868 in 2011, to recognize the effect of releasing the reinsurers from their obligations under those treaties. There was no income statement effect from this commutation.

Effective April 1, 2011, KEMI engaged in an assumptive reinsurance arrangement with Zurich American Insurance Company through which KEMI offers multi-state coverage to its policyholders. Under the agreement, Zurich writes certain policies for which KEMI assumes 100% of the business. This coverage is only available to Kentucky-based businesses that have similar operations in other states. KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2012 and 2011 includes \$693,957 and \$223,171, respectively, related to this agreement. Zurich requires KEMI to maintain a standby letter of credit in the amount of \$4,000,000. The letter of credit is collateralized by U.S. Treasury Bonds.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

Effective January 1, 2007 through March 31, 2011, KEMI engaged in an assumptive reinsurance arrangement with Argonaut Insurance Company through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Argonaut wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective March 31, 2011, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2012 and 2011 includes \$433,008 and \$773,408, respectively, related to this agreement. Argonaut requires KEMI to maintain a standby letter of credit in the amount of \$2,500,000. The letter of credit is collateralized by U.S. Treasury Bonds.

Effective January 1, 2001 through December 31, 2002, KEMI engaged in an assumptive reinsurance arrangement with Fireman's Fund through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Fireman's Fund wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective December 31, 2002, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2012 and 2011 includes \$764,702 and \$829,472, respectively, related to this agreement. Fireman's Fund requires KEMI to maintain standby letters of credit in the amount of \$1,250,000. The letters of credit are collateralized by U.S. Treasury Bonds.

KEMI reported a provision for reinsurance in the amount of \$145,892 and \$186,692 at December 31, 2012 and 2011, respectively. This provision represents net recoverables from unauthorized (foreign) reinsurers for losses, loss adjustment expenses, and unearned premiums in excess of reinsurer deposits and letters of credit. The provision for reinsurance also includes 20% of reinsurance receivables greater than 90 days past due or in dispute. None of KEMI's reinsurance receivables were overdue or in dispute at December 31, 2012 or 2011.

KEMI has the following unsecured net reinsurance recoverables outstanding for losses, paid and unpaid, including IBNR and LAE and unearned premium that individually exceeded 3% of policyholder surplus at December 31, 2012 and 2011: statutory basis

Federal ID#:	Reinsurer:	Rating:	<u>2012</u>	<u>2011</u>
AA-1120337	Aspen Insurance UK Limited	A	\$ 5,230,890	\$ 6,222,100
AA-1126435	Lloyd's Syndicate No. 435	A++	13,184,100	17,422,474
AA-1128000	Lloyd's Syndicate No. 2000	A	-	6,194,127

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

A summary of reinsurance transactions for 2012 and 2011 is as follows:

	<u>2012</u>	<u>2011</u>
Written premiums:		
Direct	\$ 125,813,031	\$ 114,334,043
Assumed	4,083,658	3,318,177
Ceded	<u>(5,673,668)</u>	<u>(4,816,238)</u>
Net	<u>\$ 124,223,021</u>	<u>\$ 112,835,982</u>
Earned premiums:		
Direct	\$ 120,742,275	\$ 110,817,105
Assumed	4,138,145	2,371,745
Ceded	<u>(5,673,668)</u>	<u>(4,816,238)</u>
Net	<u>\$ 119,206,752</u>	<u>\$ 108,372,612</u>
Incurred losses and LAE:		
Direct	\$ 94,273,103	\$ 116,406,122
Assumed	2,594,812	1,748,195
Ceded	<u>9,327,196</u>	<u>(4,011,035)</u>
Net	<u>\$ 106,195,111</u>	<u>\$ 114,143,282</u>
Unearned premiums:		
Direct	\$ 57,934,821	\$ 52,812,545
Assumed	1,352,079	1,406,566
Ceded	<u>-</u>	<u>-</u>
Net	59,286,900	54,219,111
Adjustment for earned but unbilled premiums	<u>(2,765,622)</u>	<u>(2,875,000)</u>
Net	<u>\$ 56,521,278</u>	<u>\$ 51,344,111</u>

KEMI has evaluated its reinsurance arrangements and believe they appropriately transfer risk in accordance with SSAP No. 62, *Property and Casualty Reinsurance*, and have therefore accounted for them as prospective reinsurance.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

7. Leases

KEMI leases space for its main office under a noncancellable operating lease which expires December 31, 2020. KEMI has two options to extend the lease, each for an additional 60 months following its expiration. Rental expense under this lease was \$1,011,000 and \$1,221,845 for 2012 and 2011, respectively. KEMI also leases space for a satellite office under a noncancellable operating lease which expires May 31, 2017. Rental expense under this lease was \$113,377 and \$109,409 for 2012 and 2011, respectively. The following is a summary of future minimum rental commitments for these leases:

2013	\$ 1,116,060
2014	1,116,060
2015	1,119,133
2016	1,121,328
2017	1,049,928
Thereafter	<u>2,996,784</u>
	<u>\$ 8,519,293</u>

8. Policyholder Dividend

During 2012, KEMI's Board of Directors approved a policyholder dividend in the amount of \$6.3 million. The Board authorized management to apply \$1.6 million from a 2010 dividend that was not distributed due to policyholder ineligibility, creating a net dividend paid of \$4.7 million. To be eligible, policyholders must have had a KEMI policy with a 2009 effective date and a total loss ratio of 75% or less. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status.

9. Retirement Plans

Eligible KEMI employees participate in the Kentucky Employees Retirement System (KERS). KERS is a contributory defined benefit pension plan sponsored by Kentucky Retirement Systems, in which KEMI is a member. Employees hired prior to September 1, 2008 are required to contribute 5% of gross salary to KERS, while those hired on or after September 1, 2008 are required to contribute 6% of gross salary. Employers contribute at a rate determined by the Board of Kentucky Retirement Systems to maintain the financial soundness of KERS. The employer contribution rate, which may be adjusted annually based on the actuarial valuation of KERS, was 23.61% and 19.82% at December 31, 2012 and 2011, respectively. Total pension expense paid by KEMI during 2012 and 2011 was \$2,868,789 and \$2,349,301, respectively. As of June 30, 2012, the most recent actuarial valuation date, KERS's total actuarial liability was \$12,113,747,593 and the actuarial value of assets totaled \$3,598,543,034. The portion of this obligation and the related assets attributable to KEMI's employees is relatively insignificant in relation to the plan's totals.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

9. Retirement Plans, continued

Eligible KEMI employees may also participate in the Kentucky Deferred Compensation Plan, a defined contribution plan for which KEMI matches up to 50% of the first 6% of compensation deferred by employees. Total contributions made by KEMI were \$245,386 and \$238,250 in 2012 and 2011, respectively.

10. Federal Income Taxes

As described in Note 1, KEMI is a political subdivision of the Commonwealth and was created by legislation to serve as the insurer of last resort as well as a competitive force to stabilize the workers' compensation market in Kentucky. The Commonwealth provided KEMI's initial funding and continues to influence KEMI through Governor appointed board members and through the role of oversight. For these reasons, KEMI's management believes KEMI is a tax-exempt entity pursuant to Internal Revenue Code sections §115 and §501(c)(27) and therefore not subject to federal income taxes. Accordingly, the statutory basis financial statements do not include a provision for federal income taxes.

11. Contingencies

KEMI is involved in litigation and may become involved in potential litigation arising in the ordinary course of business. Additionally, KEMI may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope of originally contemplated policies. In the opinion of management, the effects, if any, of such litigation and published court decisions are not expected to be material to the statutory basis financial statements.

12. Statutory Requirements

Under the insurance regulations of the Commonwealth of Kentucky, the amount of dividends that KEMI may pay to its policyholders is limited to the excess of actuarially determined minimum policyholder surplus requirements. Actuarially determined minimum policyholder surplus takes into consideration the company's present liabilities as well as management's expectation of future business volumes, claims activity and investment performance. The Commonwealth of Kentucky's statutory minimum policyholder surplus requirement is \$1,500,000.

DEAN || DORTON || ALLEN || FORD_{INC.}**Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards***

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the statutory basis financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI), as of and for the year ended December 31, 2012, and the related notes to the statutory basis financial statements, which collectively comprise KEMI's basic statutory basis financial statements, and have issued our report thereon dated March 28, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the statutory basis financial statements, we considered KEMI's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of KEMI's internal control. Accordingly, we do not express an opinion on the effectiveness of KEMI's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

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Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page 2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KEMI's statutory basis financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of statutory basis financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Dean Dotson Allen Ford, PLLC

March 28, 2013
Lexington, Kentucky

DEAN || DORTON || ALLEN || FORD_{PLLC}

Awareness Letter

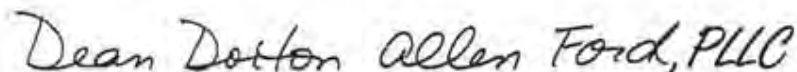
March 28, 2013

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

We have been engaged by Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) to perform annual audits of KEMI's statutory financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of the Commonwealth of Kentucky and the related rules and regulations of the Kentucky Department of Insurance that are applicable to audits of statutory financial statements of insurance entities. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of KEMI as to their conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky.

This letter is intended solely for the information and use of the board of directors and management of KEMI, the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.



March 28, 2013
 Lexington, Kentucky

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Qualification Letter

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the statutory financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) for the year ended December 31, 2012 and 2011, and have issued our report thereon dated March 28, 2013. In connection therewith, we advise you as follows:

- a) We are independent certified public accountants with respect to KEMI and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the Kentucky State Board of Accountancy.
- b) The engagement partner and the engagement manager, who are certified public accountants, have over 15 years and 7 years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most of whom have had experience in auditing insurance enterprises and 34% of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c) We understand that KEMI intends to file its audited statutory financial statements and our report thereon with the Department of Insurance of the Commonwealth of Kentucky (the Department) and that the commissioner of the Department will be relying on that information in monitoring and regulating the statutory financial condition of KEMI.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, KEMI and the Department should understand that the objective of an audit of statutory basis financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, policyholder surplus, results of operations and cash flows in conformity with accounting practices prescribed or permitted by the Department. Consequently, under auditing standards generally accepted in the United States of America, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise

due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on statutory financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of KEMI to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of statutory basis financial statements in conformity with accounting practices prescribed or permitted by the Department.

The Department should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditors' report.

- d) We will retain the workpapers prepared in the conduct of our audit until the Department has filed a Report of Examination covering 2012, but no longer than seven years. After notification to KEMI, we will make the workpapers available for review by the Department at the offices of the insurer, at our office, at the Department or at any other reasonable place designated by the Department. Furthermore, in the conduct of the aforementioned periodic review by the Department, photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Department.
- e) The engagement partner has served in that capacity with respect to KEMI since 2008, is licensed by the Kentucky State Board of Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.
- f) To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.

Dean Dotson Allen Ford, PLLC

March 28, 2013
Lexington, Kentucky

SUPPLEMENTARY INFORMATION

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement			
	1 Amount	2 Percentage	3 Amount	4 Securities Lending Reinvested Collateral Amount	5 Total (Col. 3 + 4) Amount	6 Percentage
1. Bonds:						
1.1 U.S. treasury securities:	51,671,977	7.4	51,671,977		51,671,977	7.4
1.2 U.S. government agency obligations (excluding mortgage-backed securities):						
1.21 Issued by U.S. government agencies:		0.0			0	0.0
1.22 Issued by U.S. government sponsored agencies:	579,793	0.1	579,793		579,793	0.1
1.3 Non-U.S. government (including Canada, excluding mortgage-backed securities):	1,985,002	0.3	1,985,002		1,985,002	0.3
1.4 Securities issued by states, territories and possessions and political subdivisions in the U.S.:						
1.41 States, territories and possessions general obligations:	2,164,854	0.3	2,164,854		2,164,854	0.3
1.42 Political subdivisions of states, territories and possessions and political subdivisions general obligations:	3,160,508	0.4	3,160,508		3,160,508	0.4
1.43 Revenue and assessment obligations:	40,994,896	5.8	40,994,896		40,994,896	5.8
1.44 Industrial development and similar obligations:		0.0			0	0.0
1.5 Mortgage-backed securities (includes residential and commercial MBS):						
1.51 Pass-through securities:						
1.511 Issued or guaranteed by GNMA:	1,213,607	0.2	1,213,607		1,213,607	0.2
1.512 Issued or guaranteed by FNMA and FHLMC:	97,572,588	13.9	97,572,588		97,572,588	13.9
1.513 All other:		0.0			0	0.0
1.52 CMOs and REMICs:						
1.521 Issued or guaranteed by GNMA, FNMA, FHLMC or VA:	20,061,050	2.9	20,061,050		20,061,050	2.9
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-based securities issued or guaranteed by agencies shown in Line 1.521:		0.0			0	0.0
1.523 All other:	81,713,288	11.6	81,713,288		81,713,288	11.6
2. Other debt and other fixed income securities (excluding short-term):						
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities):	276,915,746	39.4	276,915,746		276,915,746	39.4
2.2 Unaffiliated non-U.S. securities (including Canada):	63,697,781	9.1	63,697,781		63,697,781	9.1
2.3 Affiliated securities:		0.0			0	0.0
3. Equity interests:						
3.1 Investments in mutual funds:		0.0			0	0.0
3.2 Preferred stocks:		0.0			0	0.0
3.21 Affiliated:		0.0			0	0.0
3.22 Unaffiliated:		0.0			0	0.0
3.3 Publicly traded equity securities (excluding preferred stocks):		0.0			0	0.0
3.31 Affiliated:		0.0			0	0.0
3.32 Unaffiliated:	46,851,355	6.7	46,851,355		46,851,355	6.7
3.4 Other equity securities:		0.0			0	0.0
3.41 Affiliated:		0.0			0	0.0
3.42 Unaffiliated:		0.0			0	0.0
3.5 Other equity interests including tangible personal property under lease:		0.0			0	0.0
3.51 Affiliated:		0.0			0	0.0
3.52 Unaffiliated:		0.0			0	0.0
4. Mortgage loans:						
4.1 Construction and land development:		0.0			0	0.0
4.2 Agricultural:		0.0			0	0.0
4.3 Single family residential properties:		0.0			0	0.0
4.4 Multifamily residential properties:		0.0			0	0.0
4.5 Commercial loans:		0.0			0	0.0
4.6 Mezzanine real estate loans:		0.0			0	0.0
5. Real estate investments:						
5.1 Property occupied by company:		0.0			0	0.0
5.2 Property held for production of income (including \$_____ of property acquired in satisfaction of debt):		0.0			0	0.0
5.3 Property held for sale (including \$_____ of property acquired in satisfaction of debt):		0.0			0	0.0
6. Contract loans:		0.0			0	0.0
7. Derivatives:		0.0			0	0.0
8. Receivables for securities:		0.0			0	0.0
9. Securities lending (Line 10, Asset Page reinvested collateral):		0.0		XXX	XXX	XXX
10. Cash, cash equivalents and short-term investments:	14,425,190	2.1	14,425,190		14,425,190	2.1
11. Other invested assets:		0.0			0	0.0
12. Total invested assets:	703,007,633	100.0	703,007,633	0	703,007,633	100.0



SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES

For the year ended December 31, 2012

(To be filed by April 1)

OF KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

Address (City, State, Zip Code): Lexington KY 40507-1724

NAIC Group Code.....0

NAIC Company Code.....10320

Employer's ID Number.....61-1275981

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on Page 2 of this annual statement.

\$ 747,854,096

2. Ten largest exposures to a single issuer/borrower/investment.

1	2	3	4
Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets
2.01 Morgan Stanley	Long-Term Bonds	\$ 15,009,707	2.010 %
2.02 JPMorgan Chase & Co.	Long-Term Bonds & Common Stock	\$ 10,307,050	1.378 %
2.03 Wells Fargo & Co.	Long-Term Bonds & Common Stock	\$ 7,960,857	1.064 %
2.04 Citibank Credit Card Insurance Trust	Long-Term Bonds	\$ 7,137,498	0.954 %
2.05 Chase Insurance Trust	Long-Term Bonds	\$ 6,412,905	0.857 %
2.06 Centrapoint Energy Inc.	Long-Term Bonds & Common Stock	\$ 6,338,574	0.848 %
2.07 General Electric Capital Corp.	Long-Term Bonds	\$ 4,738,284	0.634 %
2.08 AT&T Inc.	Long-Term Bonds & Common Stock	\$ 4,283,050	0.573 %
2.09 Intel Corp.	Long-Term Bonds & Common Stock	\$ 4,211,713	0.563 %
2.10 Wal-Mart Stores Inc.	Long-Term Bonds & Common Stock	\$ 3,825,806	0.512 %

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

1	2
Bonds	
3.01 NAIC-1	\$ 551,026,610 73.678 %
3.02 NAIC-2	\$ 99,305,687 13.278 %
3.03 NAIC-3	\$ 0.000 %
3.04 NAIC-4	\$ 0.000 %
3.05 NAIC-5	\$ 0.000 %
3.06 NAIC-6	\$ 0.000 %
Preferred Stocks	
3.07 PIRP-1	\$ 0.000 %
3.08 PIRP-2	\$ 0.000 %
3.09 PIRP-3	\$ 0.000 %
3.10 PIRP-4	\$ 0.000 %
3.11 PIRP-5	\$ 0.000 %
3.12 PIRP-6	\$ 0.000 %

4. Assets held in foreign investments:

4.01 Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?
If response to 4.01 above is yes, responses are not required for interrogatories 5-10.

Yes [] No [X]

4.02 Total admitted assets held in foreign investments	\$ 59,797,873 7.996 %
4.03 Foreign-currency-denominated investments	\$ 0.000 %
4.04 Insurance liabilities denominated in that same foreign currency	\$ 0.000 %

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:

1	2
5.01 Countries rated NAIC-1	\$ 54,713,933 7.316 %
5.02 Countries rated NAIC-2	\$ 5,083,940 0.680 %
5.03 Countries rated NAIC-3 or below	\$ 0.000 %

6. Largest foreign investment exposures by country, categorized by the country's NAIC sovereign rating:

1	2
Countries rated NAIC-1:	
6.01 Country 1: Australia	\$ 11,528,228 1.541 %
6.02 Country 2: United Kingdom	\$ 8,625,922 1.153 %
Countries rated NAIC-2:	
6.03 Country 1: Mexico	\$ 2,994,529 0.400 %
6.04 Country 2: Brazil	\$ 2,089,411 0.279 %
Countries rated NAIC-3 or below:	
6.05 Country 1:	\$ 0.000 %
6.06 Country 2:	\$ 0.000 %

7. Aggregate unhedged foreign currency exposure \$ 0.000 %

8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign rating:

1	2
8.01 Countries rated NAIC-1	\$ 0.000 %
8.02 Countries rated NAIC-2	\$ 0.000 %
8.03 Countries rated NAIC-3 or below	\$ 0.000 %

9. Largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign rating:

	1	2
Countries rated NAIC-1:		
9.01 Country 1:	\$	0.000 %
9.02 Country 2:	\$	0.000 %
Countries rated NAIC-2:		
9.03 Country 1:	\$	0.000 %
9.04 Country 2:	\$	0.000 %
Countries rated NAIC-3 or below:		
9.05 Country 1:	\$	0.000 %
9.06 Country 2:	\$	0.000 %

10. Ten largest non-sovereign (i.e. non-governmental) foreign issues:

	1	2	3	4
	Issuer	NAIC Rating		
10.01	Stalco ASA	1	\$ 3,012,068	0.403 %
10.02	BHP Billiton Ltd.	1	\$ 2,994,541	0.400 %
10.03	America Movil Sal de Cv.	2	\$ 2,934,529	0.400 %
10.04	Royal Dutch Shell PLC	1	\$ 2,932,543	0.400 %
10.05	Korea Gas Corp.	1	\$ 2,080,510	0.399 %
10.06	Toyota Motor Corp.	1	\$ 2,496,774	0.334 %
10.07	Daimler AG	1	\$ 2,490,520	0.333 %
10.08	Westfield Group	1	\$ 2,289,554	0.306 %
10.09	Petrobras Brasileiro SA	2	\$ 2,089,411	0.279 %
10.10	UBS AG	1	\$ 2,018,517	0.270 %

11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure:

11.01	Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets?	Yes <input type="checkbox"/> No <input checked="" type="checkbox"/>
If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11.		
11.02	Total admitted assets held in Canadian investments:	\$ 24,558,870 3.284 %
11.03	Canadian currency-denominated investments:	\$ 0.000 %
11.04	Canadian-denominated insurance liabilities:	\$ 0.000 %
11.05	Unhedged Canadian currency exposure:	\$ 0.000 %

12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions:

12.01	Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets?	Yes <input checked="" type="checkbox"/> No <input type="checkbox"/>
If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.		
12.02	Aggregate statement value of investments with contractual sales restrictions:	\$ 0.000 %
Largest three investments with contractual sales restrictions:		
12.03		\$ 0.000 %
12.04		\$ 0.000 %
12.05		\$ 0.000 %

13. Amounts and percentages of admitted assets held in the ten largest equity interests:

13.01 Are assets held in equity interest less than 2.5% of the reporting entity's total admitted assets?		Yes []	No [X]
If response to 13.01 above is yes, responses are not required for the remainder of Interrogatory 13.			
	1	2	3
	<u>Name of issuer</u>		
13.02	Apple Inc.	\$ 1,633,771	0.218 %
13.03	Exxon Mobil Corp.	\$ 1,601,088	0.214 %
13.04	Microsoft Corp.	\$ 1,469,034	0.196 %
13.05	Lockheed Martin Corp.	\$ 1,361,278	0.182 %
13.06	AT&T Inc.	\$ 1,278,351	0.171 %
13.07	Chevron Corp.	\$ 1,128,008	0.151 %
13.08	Intel Corp.	\$ 1,084,303	0.146 %
13.09	Johnson & Johnson	\$ 1,045,892	0.140 %
13.10	Health Care REIT Inc.	\$ 1,035,801	0.138 %
13.11	Pliny Power Inc.	\$ 1,012,077	0.135 %

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:

14.01	Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets?	Yes <input checked="" type="checkbox"/> No <input type="checkbox"/>
If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.		
14.02	Aggregate statement value of investments held in nonaffiliated, privately placed equities:	\$ 0.000 %
Largest three investments held in nonaffiliated, privately placed equities:		
14.03		\$ 0.000 %
14.04		\$ 0.000 %
14.05		\$ 0.000 %

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:

15.01	Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets?	Yes <input checked="" type="checkbox"/> No <input type="checkbox"/>
If response to 15.01 above is yes, responses are not required for the remainder of Interrogatory 15.		
15.02	Aggregate statement value of investments held in general partnership interests:	\$ 0.000 %
Largest three investments in general partnership interests:		
15.03		\$ 0.000 %
15.04		\$ 0.000 %
15.05		\$ 0.000 %

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

Type (Residential, Commercial, Agricultural)	1		2		3	
16.02		\$			0.000 %	
16.03		\$			0.000 %	
16.04		\$			0.000 %	
16.05		\$			0.000 %	
16.06		\$			0.000 %	
16.07		\$			0.000 %	
16.08		\$			0.000 %	
16.09		\$			0.000 %	
16.10		\$			0.000 %	
16.11		\$			0.000 %	

Amount and percentage of the reporting entity's total admitted assets held in the following categories of mortgage loans:

	Loans	
16.12 Construction loans:	\$	0.000 %
16.13 Mortgage loans over 90 days past due:	\$	0.000 %
16.14 Mortgage loans in the process of foreclosure:	\$	0.000 %
16.15 Mortgage loans foreclosed:	\$	0.000 %
16.16 Restructured mortgage loans:	\$	0.000 %

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

Loan-to-Value	Residential		Commercial		Agricultural	
	1	2	3	4	5	6
17.01 above 95%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.02 91% to 95%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.03 81% to 90%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.04 71% to 80%	\$	0.000 %	\$	0.000 %	\$	0.000 %
17.05 below 70%	\$	0.000 %	\$	0.000 %	\$	0.000 %

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

18.01 Are assets held in real estate reported less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

Largest five investments in any one parcel or group of contiguous parcels of real estate:

Description	2		3	
18.02	\$	0.000 %	\$	0.000 %
18.03	\$	0.000 %	\$	0.000 %
18.04	\$	0.000 %	\$	0.000 %
18.05	\$	0.000 %	\$	0.000 %
18.06	\$	0.000 %	\$	0.000 %

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans.

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the reporting entity's admitted assets?

Yes [X] No []

If response to 19.01 is yes, responses are not required for the remainder of Interrogatory 19.

1		2		3	
19.02 Aggregate statement value of investments held in mezzanine real estate loans:	\$			0.000 %	
Largest three investments held in mezzanine real estate loans:					
19.03	\$			0.000 %	
19.04	\$			0.000 %	
19.05	\$			0.000 %	

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	At Year-End		At End of Each Quarter		
	1	2	1st Qtr	2nd Qtr	3rd Qtr
20.01 Securities lending agreements (do not include assets held as collateral for such transactions):	\$	0.000 %	\$	\$	\$
20.02 Repurchase agreements:	\$	0.000 %	\$	\$	\$
20.03 Reverse repurchase agreements:	\$	0.000 %	\$	\$	\$
20.04 Dollar repurchase agreements:	\$	0.000 %	\$	\$	\$
20.05 Dollar reverse repurchase agreements:	\$	0.000 %	\$	\$	\$

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps and floors:

	Owned		Written	
	1	2	3	4
21.01 Hedging:	\$	0.000 %	\$	0.000 %
21.02 Income generation:	\$	0.000 %	\$	0.000 %
21.03 Other:	\$	0.000 %	\$	0.000 %

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

	At Year-End		At End of Each Quarter		
	1	2	1st Qtr	2nd Qtr	3rd Qtr
22.01 Hedging:	\$	0.000 %	\$	\$	\$
22.02 Income generation:	\$	0.000 %	\$	\$	\$
22.03 Replications:	\$	0.000 %	\$	\$	\$
22.04 Other:	\$	0.000 %	\$	\$	\$

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

	At Year-End		At End of Each Quarter		
	1	2	1st Qtr 3	2nd Qtr 4	3rd Qtr 5
23.01 Hedging	\$	0.000 %	\$	\$	\$
23.02 Income generation	\$	0.000 %	\$	\$	\$
23.03 Replications	\$	0.000 %	\$	\$	\$
23.04 Other	\$	0.000 %	\$	\$	\$

**KENTUCKY EMPLOYERS' MUTUAL
INSURANCE AUTHORITY dba KENTUCKY
EMPLOYERS' MUTUAL INSURANCE
Statutory Basis Financial Statements and
Supplementary Information**

*Years Ended December 31, 2011 and 2010
with Independent Auditors' Report Thereon*

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DEAN || DORTON || ALLEN || FORD_{PLLC}**Independent Auditors' Report**

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

We have audited the accompanying statements of admitted assets, liabilities and policyholder surplus - statutory basis of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) as of December 31, 2011 and 2010, and the related statements of income - statutory basis and cash flows - statutory basis and changes in policyholder surplus - statutory basis for the years then ended. These statutory basis financial statements are the responsibility of KEMI's management. Our responsibility is to express an opinion on these statutory basis financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statutory basis financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statutory basis financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note 2 to the financial statements, KEMI prepared these statutory basis financial statements using accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky, which practices differ from accounting principles generally accepted in the United States of America. The effects on the statutory basis financial statements of the variances between the statutory basis accounting and generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance as of December 31, 2011 and 2010, or the results of its operations or its cash flows for the years then ended.

In our opinion, the statutory basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholder surplus of KEMI as of December 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note 2.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page 2

In accordance with *Government Auditing Standards*, we have also issued our report dated March 29, 2012 on our consideration of KEMI's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Our audits were conducted for the purpose of forming an opinion on the statutory basis financial statements as a whole. The management's discussion and analysis on pages 3 - 8 and the supplementary information included in the accompanying Summary Investment Schedule and Supplemental Investment Risks Interrogatories are presented for purposes of additional analysis and are not a required part of the statutory basis financial statements but are supplementary information required by the Governmental Accounting Standards Board and statutory accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the statutory basis financial statements. The information has not been subjected to the auditing procedures applied in the audits of the statutory basis financial statements. Accordingly, it is inappropriate to and we do not express an opinion on the supplementary information referred to above.

A handwritten signature in black ink, reading "Dean Dorton Allen Ford, PECC". The signature is written in a cursive, flowing style.

March 29, 2012
Lexington, Kentucky

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2011 MANAGEMENT'S DISCUSSION AND ANALYSIS**

OBJECTIVE AND BACKGROUND

This discussion provides an assessment by management of the current financial position, results of operations, cash flow and liquidity of Kentucky Employers' Mutual Insurance Authority (KEMI, or the Company). Information presented in this discussion supplements KEMI's 2011 audited statutory basis financial statements, as well as the schedules and exhibits included in KEMI's 2011 Annual Statement filed with the Department of Insurance of the Commonwealth of Kentucky.

KEMI is a unique entity in the Kentucky workers' compensation insurance marketplace. KEMI operates as a self-supporting, competitive state fund created for the purpose of providing both a market of last resort for employers in the Commonwealth, as well as furnishing another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage. KEMI performs its duties under authority granted directly to it by the Kentucky General Assembly. Except for items specifically addressed in its enabling statute, KEMI operates as a domestic mutual insurance company. KEMI began writing business effective September 1, 1995.

KEMI is governed by a ten member board of directors. Seven board members are appointed by the Governor and three board members are specified cabinet secretaries. The board is responsible for hiring a manager, and both the board and the manager are given specific statutory duties.

The Company has set about to apply fiscal responsibility to the administration of workers' compensation insurance by keeping the cost of coverage affordable to all employers in the Commonwealth through increased competition and superior service. The Company allows each policyholder to control its own destiny in the marketplace. KEMI has no public funding and sets its standards based on long-term financial stability. KEMI does, in fact, make workers' comp work.

FINANCIAL POSITION

The Statement of Admitted Assets, Liabilities and Policyholder Surplus reflects KEMI's financial position at year end. KEMI's condensed Statements of Admitted Assets, Liabilities and Policyholder Surplus (balance sheets) as of December 31 were as follows:

	<u>2011</u>	<u>2010</u>
Admitted Assets:		
Long-term bonds and common stocks	\$ 644,607,564	\$ 600,579,203
Cash and short-term investments	25,116,986	13,609,705
Premium balances	33,737,094	32,564,939
Other assets	<u>6,030,766</u>	<u>6,559,048</u>
 Total assets	 \$ <u>709,492,410</u>	 \$ <u>653,312,895</u>

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2011 MANAGEMENT'S DISCUSSION AND ANALYSIS**

	<u>2011</u>	<u>2010</u>
Liabilities and Policyholder Surplus:		
Unpaid losses and loss adjustment expenses	\$ 476,585,556	\$ 423,913,532
Unearned premiums	54,219,111	49,914,363
Funds held under reinsurance treaties	0	18,677,001
Other liabilities	<u>19,099,968</u>	<u>17,127,702</u>
Total liabilities	549,904,635	509,632,598
Policyholder surplus	<u>159,587,775</u>	<u>143,680,297</u>
 Total liabilities and policyholder surplus	 \$ <u>709,492,410</u>	 \$ <u>653,312,895</u>

During 2011, KEMI's policyholder surplus increased by \$15,907,478. Items that positively affected surplus were net investment income of \$26,732,636, net realized capital gains of \$20,857,404, net unrealized capital gains of \$666,190 and a decrease in non-admitted assets of \$2,363,147. These positives were offset by a net underwriting loss of \$32,831,012, non-admitted premium balances written off to bad debt expense of \$1,843,575 (net of \$119,406 in balances recovered and \$680 in fees for non-sufficient funds) and an increase in the statutory provision for reinsurance of \$37,312.

Assets

Net cash flows from operations amounted to \$54,708,110 for 2011 versus \$26,644,397 (\$55,093,272 before policyholder dividend payments of \$28,448,875) for 2010. KEMI's total cash and invested assets grew by \$55,535,642, or 9.04%. Net cash placed in the investment portfolio was \$23,381,988 for 2011. Investment grade bonds are stated at amortized cost while non-investment grade bonds, if any, are stated at the lower of amortized cost or fair market value. At the end of 2011, the total book value of KEMI's long-term bonds was \$601,127,804. The bond portfolio had an effective duration of 5.29 years, an average book yield of 4.05% and an average credit rating of Aa3/AA-. Common stocks, which are stated at fair market value as determined by the Securities Valuation Office of the NAIC, totaled \$43,479,760 and reflected a net unrealized gain of \$4,886,153 at the end of 2011. Cash and short-term investments, which are stated at fair market value, totaled \$25,116,986. The fair market value of KEMI's total cash and invested assets was \$706,148,392.

Investments with an unrealized loss are evaluated on a case by case basis to determine whether the decline in value is potentially permanent. If management deems a security to be permanently impaired, KEMI recognizes an Other Than Temporary Impairment (OTTI) realized loss on that security. In order to maintain a high quality portfolio, it is KEMI's practice to dispose of any security with an OTTI write-down. At the end of 2011, KEMI had no investments nearing OTTI status.

As a result of payment plan arrangements that KEMI offers to its policyholders, \$27,109,051 of the \$33,737,094 in premium balances reflected on the 2011 balance sheet were recorded, but the billings have been deferred and are not yet due. In addition, Statutory Accounting Principles require management to estimate the amount of premium that will be earned but unbilled at the end of each policy in force based upon past policy audit experience. Management's estimate of \$2,587,500 is included in KEMI's premium balances.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2011 MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-admitted assets are those assets which, under Statutory Accounting Principles, must be excluded from the balance sheet by a direct charge to surplus. At the end of 2011, KEMI's non-admitted assets totaled \$7,607,839, down from \$9,970,986 at the end of 2010. The bulk of KEMI's non-admitted assets, or \$6,359,571, is comprised of premium balances that are more than 90 days past due or otherwise determined to be uncollectible. The collectability of these receivables is regularly assessed and written off to bad debt only after all efforts to secure payment have been exhausted. During 2011, uncollectible premium balances of \$1,963,661 were written off to bad debt expense. Other non-admitted assets are furniture, equipment and application software of \$415,121, prepaid expenses of \$335,000 and other receivables of \$498,147.

Liabilities

Reserves for unpaid losses and loss adjustment expenses are stated at the Company's estimate of the ultimate cost, net of ceded reinsurance, of settling all incurred but unpaid claims. Unpaid loss and loss adjustment expense reserves are based upon Company history and industry statistics, along with management's loss expectations based upon current premium levels. The method for making such estimates and for establishing the resulting liability is continually reviewed and any adjustments are reflected in the period determined. KEMI's reserves for unpaid losses and loss adjustment expenses are not discounted. Management believes that its loss reserving methodologies are conservative and that the Company's reserves are adequate. KEMI's reserves are evaluated annually by an independent third party actuary who provides a Statement of Actuarial Opinion to KEMI's independent auditors and to regulatory agencies. KEMI received an Unqualified Statement of Actuarial Opinion for 2011, as it has every year since its inception.

Activity with respect to losses and loss adjustment expenses, net of the effects of reinsurance, is displayed below:

	<u>2011</u>	<u>2010</u>
Unpaid losses and loss adjustment expenses, January 1	\$ 423,913,532	\$ 389,413,722
Losses and loss adjustment expenses incurred:		
Losses	93,352,921	77,269,018
Loss adjustment expenses	<u>20,790,364</u>	<u>19,279,152</u>
Total incurred	<u>114,143,285</u>	<u>96,548,170</u>
Losses and loss adjustment expenses paid:		
Losses	43,137,257	44,594,444
Loss adjustment expenses	<u>18,334,004</u>	<u>17,453,916</u>
Total paid	<u>61,471,261</u>	<u>62,048,360</u>
Unpaid losses and loss adjustment expenses, December 31	\$ <u>476,585,556</u>	\$ <u>423,913,532</u>

In 2011, KEMI recorded a \$15 million charge to loss reserves to cover the anticipated impact of benefit provisions included in last year's healthcare reform act. Better known as the Byrd Amendment, these provisions make it easier for coal miners or their widows to obtain workers' compensation benefits for black lung disease. To offset the impact of this charge, KEMI took approximately \$15 million in capital gains from the sale of long-term bonds.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2011 MANAGEMENT'S DISCUSSION AND ANALYSIS

Adjustments made in 2011 and 2010 to the reserves for unpaid losses and loss adjustment expenses of prior accident years resulted in net increases to the reserves totaling \$12,593,583 and \$7,303,455, respectively. These adjustments were charged to expense as losses and loss adjustment expenses incurred.

At the end of 2011, KEMI had 4,501 open claims from direct business and 51 open claims from business assumed under the Company's multi-state program. Approximately 50% of these open claims occurred during 2011.

Policyholder Surplus

KEMI's net financial position remained strong in 2011. Management regularly reviews premium levels, expenditures and investment performance to maintain the Company's sound financial footing. Looking forward modest increases to surplus are expected, primarily from net investment income. As the economy continues to recover, the Company expects to see slight gains in direct written premiums due to increasing policyholder payrolls. Excluding the effects of the Byrd Amendment as described above, losses, loss adjustment expenses and overall operating expenses are expected to remain relatively flat in 2012.

KEMI continually monitors its leverage position as it relates to premium and loss reserve volume compared to surplus levels. The Company calculates its Risk Based Capital requirement annually in accordance with NAIC regulations. KEMI's surplus for 2011 was well within established guidelines.

In 2010, KEMI's Board of Directors approved a special, one-time dividend payable to current and past policyholders in the amount of \$30.8 million. To be eligible, policyholders must have had a KEMI policy for at least six months from 1995 through 2008, must have had at least \$350 in earned premiums, must have had a total loss ratio of less than 75%, and must have been in existence on the date the dividend was approved. KEMI's Board authorized management to recover from any dividend payable those amounts written off to bad debt and those amounts in outstanding collections status. No dividend was declared in 2011.

RESULTS OF OPERATIONS

The Statement of Income measures the results of operations during the reporting period. KEMI's condensed Statements of Income for the years ended December 31 were as follows:

	<u>2011</u>	<u>2010</u>
Premiums earned	\$ 108,372,612	\$ 105,465,155
Losses and loss adjustment expenses incurred	114,143,285	96,548,170
Other underwriting expenses	<u>27,060,339</u>	<u>24,015,535</u>
Underwriting loss	(32,831,012)	(15,098,550)
Net investment income	26,732,636	26,900,775
Net realized capital gains	20,857,404	4,963,199
Other expenses	<u>(1,843,575)</u>	<u>(3,913,342)</u>
Net operating gain	12,915,453	12,852,082
Policyholder dividends	<u>0</u>	<u>(30,800,011)</u>
Net income (loss) after policyholder dividends	\$ <u>12,915,453</u>	\$ <u>(17,947,929)</u>

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2011 MANAGEMENT'S DISCUSSION AND ANALYSIS**

KEMI's direct written premiums were \$114,334,043 for 2011, reflecting a 7.7% increase from 2010. This increase is primarily attributed to the improving economy and the presence of larger workforces. KEMI held overall rates flat in its last rate filing effective October 1, 2011. KEMI filed no rate changes in 2010, and its 2009 rate filing reflected an overall reduction of 6.0%. These rating actions exemplify KEMI's mission of making workers' compensation coverage affordable to employers by adhering to financially responsible underwriting practices.

CASH FLOW AND LIQUIDITY

Cash Flow

The Statement of Cash Flows reports cash provided and used by operations, investments, financing and miscellaneous activities during the reporting period. KEMI's condensed Statements of Cash Flows for the years ended December 31 were as follows:

	<u>2011</u>	<u>2010</u>
Cash Flows from Operations:		
Net cash from underwriting activities	\$ 28,642,751	\$ 31,546,480
Investment income received	28,370,856	27,460,134
Policyholder dividend payments	(461,922)	(28,448,875)
Other expenses	<u>(1,843,575)</u>	<u>(3,913,342)</u>
Net cash provided from operations	<u>54,708,110</u>	<u>26,644,397</u>
Cash Flows from Investments:		
Proceeds from investments sold or matured	300,964,645	130,080,418
Cost of investments acquired	<u>(324,346,633)</u>	<u>(133,658,219)</u>
Net cash used for investments	<u>(23,381,988)</u>	<u>(3,577,801)</u>
Cash Flows from Miscellaneous Activities:		
Other cash applied	<u>(19,818,841)</u>	<u>(18,964,743)</u>
Net cash used for miscellaneous activities	<u>(19,818,841)</u>	<u>(18,964,743)</u>
 Net change in cash and short-term investments	 11,507,281	 4,101,853
 Cash and short-term investments, beginning of year	 <u>13,609,705</u>	 <u>9,507,852</u>
 Cash and short-term investments, end of year	 \$ <u>25,116,986</u>	 \$ <u>13,609,705</u>

Liquidity

KEMI invests policyholder premiums in assets whose maturities closely match the actuarial expected payout of the related losses and loss adjustment expenses. Funds available for investment, which exceed the estimated amounts required to eventually satisfy liabilities, are primarily invested in long-term bonds. KEMI maintains a very liquid bond portfolio with an effective duration of 5.29 years, and KEMI's equity positions are all actively traded on major exchanges. KEMI has sufficient cash resources available to meet its liabilities as they come due.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2011 MANAGEMENT'S DISCUSSION AND ANALYSIS

NOTE: To the extent that the above comments constitute forward-looking statements, these statements are not guarantees of future performance. Forward-looking statements are based on current expectations and projections about future events and are subject to risks, uncertainties and assumptions about the Company, economic and market factors, judicial rulings and the insurance industry, among other things. Actual events and results may differ materially from those expressed in forward-looking statements.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Admitted Assets, Liabilities and Policyholder Surplus - Statutory Basis

December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Admitted Assets		
Long-term bonds	\$ 601,127,804	\$ 574,798,981
Common stock	43,479,760	25,780,222
Cash and short-term investments	25,116,986	13,609,705
Investment income due and accrued	5,500,203	6,167,884
Premiums in course of collection	6,628,043	6,740,787
Premiums booked but deferred and not yet due	27,109,051	25,824,152
Reinsurance receivable on losses and loss adjustment expenses	262,792	327,749
Electronic data processing equipment at cost, less accumulated depreciation of \$3,397,665 and \$3,154,969 in 2011 and 2010, respectively	<u>267,771</u>	<u>63,415</u>
Total admitted assets	<u>\$ 709,492,410</u>	<u>\$ 653,312,895</u>
Liabilities and Policyholder Surplus		
Unpaid losses	\$ 440,160,938	\$ 389,945,274
Unpaid loss adjustment expenses	36,424,618	33,968,258
Commissions payable	6,335,021	3,484,526
Unearned premiums	54,219,111	49,914,363
Amounts withheld or retained for others	6,351,952	6,598,788
Reinsurance premiums paid in advance	(608,753)	(859,294)
Remittances and items not allocated	949,784	1,286,282
Funds withheld under reinsurance treaties	-	18,677,001
Policyholder dividend payable	1,889,214	2,351,136
Other liabilities	<u>4,182,750</u>	<u>4,266,264</u>
Total liabilities	549,904,635	509,632,598
Policyholder surplus	<u>159,587,775</u>	<u>143,680,297</u>
Total liabilities and policyholder surplus	<u>\$ 709,492,410</u>	<u>\$ 653,312,895</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Income - Statutory Basis

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Premiums earned:		
Direct	\$ 110,817,105	\$ 108,721,576
Assumed	2,371,745	1,380,473
Ceded	<u>(4,816,238)</u>	<u>(4,636,894)</u>
	108,372,612	105,465,155
Losses incurred:		
Direct	95,935,718	80,212,196
Assumed	1,388,724	572,230
Ceded	<u>(3,971,521)</u>	<u>(3,515,408)</u>
	93,352,921	77,269,018
Loss adjustment expenses	20,790,364	19,279,152
Commissions and brokerage fees	13,924,615	8,885,116
Other underwriting expenses	<u>13,135,724</u>	<u>15,130,419</u>
Total underwriting expenses	<u>141,203,624</u>	<u>120,563,705</u>
Net underwriting loss	(32,831,012)	(15,098,550)
Investment income, net of investment expenses of \$1,452,414 and \$1,196,777 in 2011 and 2010, respectively	26,732,636	26,900,775
Net realized capital gains	20,857,404	4,963,199
Bad debt and other expenses	<u>(1,843,575)</u>	<u>(3,913,342)</u>
Net income before policyholder dividend	12,915,453	12,852,082
Policyholder dividend	<u>-</u>	<u>30,800,011</u>
Net income (loss)	\$ <u>12,915,453</u>	\$ <u>(17,947,929)</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Changes in Policyholder Surplus - Statutory Basis

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Policyholder surplus, beginning of year	\$ 143,680,297	\$ 153,997,880
Net income (loss)	12,915,453	(17,947,929)
Change in net unrealized gains on investments	666,190	2,842,889
Change in non-admitted assets	2,363,147	4,907,387
Change in provision for reinsurance	<u>(37,312)</u>	<u>(119,930)</u>
Policyholder surplus, end of year	\$ <u>159,587,775</u>	\$ <u>143,680,297</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Cash Flows - Statutory Basis

Years ended December 31, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:		
Premiums collected, net of reinsurance	\$ 113,834,536	\$ 116,253,055
Investment income, net of investment expenses	28,370,856	27,460,134
Miscellaneous expenses	(1,843,575)	(3,913,342)
Benefit and loss related payments	(43,072,300)	(44,652,674)
Commissions, expenses paid and aggregate write-ins	(42,119,485)	(40,053,901)
Dividend paid to policyholders	<u>(461,922)</u>	<u>(28,448,875)</u>
Net cash provided by operating activities	54,708,110	26,644,397
Cash flows from investing activities:		
Proceeds from investments sold or matured	300,964,645	130,080,418
Cost of investments acquired	<u>(324,346,633)</u>	<u>(133,658,219)</u>
Net cash used in investing activities	(23,381,988)	(3,577,801)
Cash flows from miscellaneous activities:		
Other cash applied	<u>(19,818,841)</u>	<u>(18,964,743)</u>
Net change in cash and short-term investments	11,507,281	4,101,853
Cash and short-term investments, beginning of year	<u>13,609,705</u>	<u>9,507,852</u>
Cash and short-term investments, end of year	\$ <u>25,116,986</u>	\$ <u>13,609,705</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements

1. Description of Organization

Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) is a non-profit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). KEMI was established by legislation of the Commonwealth enacted April 4, 1994 to serve as a competitive state fund for the purpose of providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage as required by state law. KEMI began writing business effective September 1, 1995.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying statutory basis financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky (the Department). The Department recognizes only statutory accounting practices prescribed or permitted by the Commonwealth of Kentucky for determining the solvency under the Kentucky insurance law. The National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual* has been adopted as a component of prescribed or permitted practices by the Commonwealth of Kentucky. The Department has the right to permit other specific practices that deviate from the prescribed practices. However, KEMI does not employ any such practices.

These statutory accounting practices comprise a comprehensive basis of accounting other than accounting practices generally accepted in the United States of America (GAAP) and differ in some respects. Some of the more significant of these differences are as follows:

- a. Investments in bonds with an NAIC rating of 1 or 2 are carried at NAIC determined value or amortized cost, whereas bonds with a NAIC rating of 3 through 6 are assigned specific year-end values by the NAIC and are written down to Securities Valuation Office (SVO) assigned values (if less than amortized cost) by charging statutory policyholder surplus. Under GAAP, bonds are classified into three categories: held to maturity, available for sale, and trading. Bonds held to maturity are stated at amortized cost; bonds available for sale are stated at fair value and the resulting unrealized gains or losses, net of applicable income taxes, are charged or credited to policyholder surplus; and bonds held for trading are reported at fair value and the resulting unrealized gains and losses are reported in earnings, net of related taxes.

The fair value of investments on a statutory basis is determined by the SVO, whereas for GAAP, the fair value of investments is determined based on the expected exit price.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

For loan-backed and structured securities, if the company determines that a security is impaired and they intend to sell the security or no longer have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security shall be written down to fair value. For statutory purposes, if the company subsequently changes their assertion, and now believe they do not intend to sell the security and have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security will continue to be carried at the lower of cost or market with any future decreases in fair value charged through operations until the security is disposed. For GAAP purposes, once the company alters their assertion, that security's amortized cost basis will not be decreased for future reductions in fair value unless an other than temporary impairment is determined to have occurred.

Also, for GAAP purposes, other-than-temporary impairment losses (related to non loan-backed and structured securities) related to debt securities are bifurcated between credit and non-credit, where for statutory purposes the total other-than-temporary impairment loss is reported in earnings.

b. Assets having economic value other than those that can be used to fulfill policyholder obligations are categorized as "nonadmitted assets" and are not permitted to be included in the statutory financial statements of admitted assets, liabilities, and policyholder surplus, whereas, for GAAP, these assets are recognized in the balance sheet. Included with nonadmitted assets are furniture, equipment and supplies, prepaid expenses, certain receivables and other items that do not meet statutory criteria for admitted assets.

c. Receivables over 90 days outstanding are not admitted to the statutory financial statements and charged to policyholder surplus, whereas, for GAAP, the company assesses the collectability of premiums receivable and any charge is to the income statement.

d. The statutory financial statements are presented net of the effects of reinsurance, whereas, for GAAP, the financial statements are presented gross of the effects of reinsurance.

e. Guaranty fund assessments are generally available for recoupment from policyholders and as such, amounts assessed are recorded as a recoverable asset. Under GAAP, these assessments against the company are expensed when incurred and subsequently recorded as revenue when collected from the policyholders. Assessments against the policyholders are shown as a liability.

f. Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and, to the extent recoverable, amortized with deferred policy acquisition costs, as required under GAAP.

g. Comprehensive income is not determined for statutory reporting purposes, whereas, for GAAP, such income is recognized.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

h. Costs incurred in connection with acquiring new insurance business, including commissions, are charged against statutory earnings as such costs are incurred, while, under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective periods covered by the related policies.

i. A statutory liability has been established and charged to policyholder surplus for amounts due from unauthorized reinsurers in excess of letters of credit, funds held, and premiums payable. Under GAAP, no such liability is provided.

j. The statutory statement of cash flows differs in certain respects from the presentation required within GAAP literature, including the presentation of changes in cash and short-term investments instead of cash and cash equivalents.

k. The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements that KEMI files with the NAIC and the state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP reporting.

The effect of the differences between statutory accounting practices and accounting principles generally accepted in the United States of America has not been determined, but is presumed to be material.

Risks and Uncertainties

Certain risks and uncertainties are inherent to KEMI's day-to-day operations and to the process of preparing its statutory basis financial statements. The more significant of those risks and uncertainties are presented below and throughout the notes to the statutory basis financial statements.

Use of Estimates - The preparation of the statutory basis financial statements requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statutory basis financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of unpaid losses and loss adjustment expenses. In connection with the determination of this liability, management uses the methodology described in *Unpaid Losses and Loss Adjustment Expenses* later in this footnote. While management uses the best information available to estimate unpaid losses and loss adjustment expenses, future changes to the liability may be necessary based on claims experience and changing claims frequency and severity conditions, as well as changes in doctrines of legal liability and damage awards in Kentucky. The future changes will be charged or credited to expense when they occur.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Loss Reserves - KEMI estimates losses and loss adjustment expenses (LAE) based on the accumulation of case estimates and loss reports, as well as estimates of incurred but not reported (IBNR) losses, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported and unreported claims and incidents. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Actual results could differ from these estimates.

Reinsurance - Reinsurance contracts do not relieve KEMI from its obligations to insureds. Failure of reinsurers to honor their obligations could result in losses to KEMI. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Management believes that any liability arising from this contingency would not be material to KEMI's financial position.

Investment Risk - KEMI is exposed to risks that issuers of securities owned by KEMI will default or that interest rates will change and cause a decrease in the value of its investments. With mortgage-backed securities, KEMI is exposed to credit risk and prepayment risk.

As interest rates decline, the velocity at which these securities pay down the principal will increase. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

KEMI maintains balances at financial institutions that exceed federally insured limits; however, it also utilizes repurchase agreements and money market funds to mitigate this risk. KEMI's management continually evaluates the financial stability of these financial institutions, and does not believe they are exposed to unnecessary risk.

Since most of KEMI's investments consist of securities that are traded in the public securities markets, they are subject to risk related to fluctuations in overall market performance and are potentially subject to heightened levels of market risk attributable to issuer, industry, and geographic region concentrations. KEMI's investment portfolio is regularly reviewed and the extent of its diversification is considered in the context of statutory requirements and other risk management and performance objectives.

External Factors - KEMI is highly regulated by the state in which it is domiciled. Such regulations, among other things, limit the amount of dividends and impose restrictions on the amount and types of investments. In addition, from time to time, KEMI may be affected by changes in federal regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), or the Patient Protection and Affordable Care Act (PPACA). Additionally, the PPACA contained an amendment with specific language related to black lung claims (the Byrd Amendment). KEMI continues to monitor the impact of such regulations and will assess any potential impact of these changes.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Risk-Based Capital - The NAIC has developed property-casualty risk-based capital (RBC) standards that relate an insurer's reported statutory capital and policyholder surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to protect KEMI from the various risks that it faces. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. KEMI continues to monitor its internal capital requirements and the NAIC's RBC requirements. KEMI has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that KEMI's capital levels are sufficient to support the level of risk inherent in its operations.

Investments

Investments, excluding residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies, are stated at values prescribed by the NAIC's Security Valuation Office (SVO), which generally are as follows:

Non loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method with bonds containing call provisions being amortized to the call or maturity date, whichever results in a lower asset value. Loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method including anticipated prepayments. Bonds rated 3 through 6 are carried at fair value with the change run through policyholder surplus.

Investments in residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies utilize a financial model commissioned by the NAIC to determine credits ratings, and ultimately the NAIC designation/rating. This financial model requires a two step process. KEMI first determines the initial rating designation based upon each security's amortized cost in relation to security specific prescribed break points. This initial rating designation determines whether the security will be stated at amortized cost or fair value, based on the same criteria noted in the preceding paragraph. (The lower the amortized cost relative to par, the higher the NAIC designation, and more likely the security will be carried at amortized cost.) If the security is to be carried at fair value, KEMI then determines the final rating designation based upon each security's fair value in relation to the same security specific prescribed break points used in the first step. If the security is to be carried at amortized cost, the final designation remains the same as what was determined in the first step. The final designation is used for RBC purposes as well as for NAIC designation disclosure purposes.

Investments in preferred stocks with an NAIC rating designation of 1 or 2 are stated at amortized cost; all other preferred stocks are stated at the lesser of amortized cost or fair value.

Investments in common stocks are stated at fair value with unrealized gains and losses being reported as a separate component of unassigned policyholder surplus.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Investments, continued

Realized gains or losses are determined on the specific-identification method. Investment income is recognized as earned, net of related investment expenses. Bond premiums and discounts are amortized by the scientific-yield method and are charged or credited to net investment income. For mortgage-backed securities, KEMI anticipates prepayments utilizing published data in applying interest income.

The assessment of other-than-temporary impairments is performed on a case-by-case basis. Factors considered by management in determining whether an other-than-temporary impairment exists (in other than loan-backed or structured securities) include: the financial condition, business prospects and creditworthiness of the issuer, the length of time and extent to which fair value has been less than cost for equity securities or amortized cost for fixed income securities, and KEMI's intent and ability to retain such investments until the fair value recovers. If it is determined that the decline in fair market value is other than temporary, the carrying amount of the investment is written down to fair value as its new basis and the amount of the write-down is recorded as a realized loss.

For loan-backed or structured securities, factors considered by management in determining whether an other-than-temporary impairment exists include: KEMI's stated intent to not sell, KEMI's ability to hold such investments until the fair value recovers, and the discounted cash flows of the security based on the yield at the date of acquisition. If KEMI intends to sell or if KEMI does not have the ability and intent to hold the security for a period of time sufficient to recover its amortized cost basis, an other-than-temporary impairment exists, and the security is written down to fair value with the amount of the write-down recorded as a realized loss. If KEMI does not intend to sell the security and has the ability and intent to hold the security for a period of time sufficient to recover the amortized cost basis, KEMI calculates the cash flows expected to be collected. In this calculation, KEMI compares the present value of cash flows expected to be collected, discounted at the security's effective interest rate at date of purchase, to the amortized cost basis. If the present value of cash flows is less than the amortized cost basis, a realized loss is recorded for the difference. The present value of cash flows then becomes the new cost basis.

KEMI uses the prospective method to accrete the amortized cost basis to the ultimate expected cash flows.

Premiums

Premiums are earned on the daily pro-rata method over the policy period and are stated after deduction for reinsurance. Unearned premiums represent the portion of initial premiums written that are applicable to the unexpired terms of policies in force. Initial premiums are recorded as premiums written on the policy effective date except for certain premiums that are recorded on an installment basis. Any subsequent additional premiums or refunds that occur as a result of policy audits are recorded as written premiums at the time the policy audits are finalized. Earned but unbilled premiums represent management's estimate of future audit premiums and are included in premiums booked but deferred and not yet due.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Premiums, continued

Premiums in course of collection which are customer obligations due under normal terms requiring payment by the policy due date, and premiums booked but deferred and not yet due are valued at their carrying amount, which approximates fair value. Receivables over 90 days outstanding are not admitted to the statutory financial statements.

Unpaid Losses and Loss Adjustment Expenses

The estimated liability for losses is based on the accumulation of case estimates for claims and incidents reported, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported claims and incidents. Also included in the liability for losses are estimates of incurred but not reported losses based on historical experience adjusted for current trends. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Estimates for loss and related LAE are made without regard to the time value of money.

Management believes that the provisions for losses and LAE are adequate to cover the net cost of claims incurred and incidents reported; however, the provisions are necessarily based upon estimates and, therefore, the ultimate liability may be less than or exceed such estimates. As adjustments become necessary in these estimates, such adjustments are reflected in the results of operations in the period in which they are determined.

The reserves for unpaid losses are net of anticipated subrogation.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums, losses, and loss adjustment expenses are reported net of reinsured amounts. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. KEMI holds funds and collateral as security under reinsurance agreements in the form of letters of credit for any reinsurers not subject to the regulation of the Kentucky Commissioner of Insurance. In the opinion of management, all amounts due from reinsurers at December 31, 2011 and 2010 are recoverable.

Cash and Short-Term Investments

Cash and short-term investments consist of cash on deposit with financial institutions and investments with original maturities of less than one year at the date of acquisition. These investments are carried at cost, which approximates fair value.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Concentrations of Geographic and Credit Risk

All of KEMI's total direct gross written premiums of \$114,334,043 for the year ended December 31, 2011 were for insureds in Kentucky.

The credit quality of the bond portfolio at December 31, 2011 is presented is as follows:

	<u>Carrying Value</u>	<u>Percentage</u>
Class 1 - highest quality	\$ 517,512,412	86.1 %
Class 2 - high quality	<u>83,615,392</u>	<u>13.9</u>
Total	\$ <u>601,127,804</u>	<u>100 %</u>

Bonds with ratings from AAA to BBB as assigned by Standard & Poor's Corporation are generally considered as investment grade securities. Some securities issued by the U.S. government or an agency thereof are not rated but are considered to be investment grade. The NAIC regards U.S. Treasuries and agencies and all A ratings as Class 1 (highest quality), BBB ratings as Class 2 (high quality), BB ratings as Class 3 (medium quality), B ratings as Class 4 (low quality), C ratings as Class 5 (lower quality), and D ratings as Class 6 (in or near default).

Property and Equipment

Electronic data processing equipment, including operating software, is stated at cost less accumulated depreciation. Depreciation expense on such property was \$242,696 and \$149,601 in 2011 and 2010, respectively. Furniture, office equipment, and application software are non-admitted assets under statutory accounting practices. Depreciation expense on such property was \$395,811 and \$618,732 in 2011 and 2010, respectively.

Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. Gains and losses on the sale of property and equipment are recorded in the year of disposition. Maintenance and repairs are expensed as incurred; replacements and betterments are capitalized.

Advertising

KEMI expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2011 and 2010, was \$790,488 and \$1,009,606, respectively.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Reclassifications

Certain amounts of an immaterial nature in the 2010 financial statements have been reclassified to conform to the 2011 presentation with no net impact to net loss or policyholder surplus.

Subsequent Events

All of the effects of subsequent events that provide additional evidence about conditions that existed at the statement of admitted assets, liabilities and policyholder surplus date, including the estimates inherent in the process of preparing the statutory basis financial statements, are recognized in the statutory basis financial statements. KEMI does not recognize subsequent events that provide evidence about conditions that did not exist at the statement of admitted assets, liabilities and policyholder surplus date but arose after, but before the statutory basis financial statements are available to be issued. In some cases, nonrecognized subsequent events are disclosed to keep the statutory basis financial statements from being misleading.

Management has evaluated subsequent events for accounting and disclosure requirements through March 29, 2012, the date that the statutory basis financial statements were available to be issued. There were no events occurring during the evaluation period that require recognition or disclosure in the statutory basis financial statements.

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Notes to the Statutory Basis Financial Statements, continued

3. Investments

Long-Term Bonds

The carrying value/adjusted cost, gross unrealized gains, gross unrealized losses, and the estimated fair value of investments in bonds are summarized as follows:

	Statement Value	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
As of December 31, 2011:				
U.S. government	\$ 74,955,081	\$ 3,630,830	\$ -	\$ 78,585,911
U.S. special revenue	148,465,949	8,243,364	(70,377)	156,638,936
State government	2,164,622	71,424	-	2,236,046
All other governments	2,646,129	121,052	-	2,767,181
Political subdivisions	3,167,785	142,215	-	3,310,000
Corporate securities	<u>369,728,238</u>	<u>25,142,252</u>	<u>(856,918)</u>	<u>394,013,572</u>
	<u>\$ 601,127,804</u>	<u>\$ 37,351,137</u>	<u>\$ (927,295)</u>	<u>\$ 637,551,646</u>
As of December 31, 2010:				
U.S. government	\$ 94,009,062	\$ 6,782,626	\$ (877,851)	\$ 99,913,837
U.S. special revenue	126,754,869	7,804,824	(246,685)	134,313,008
State government	2,164,399	11,304	(109,731)	2,065,972
All other governments	4,836,972	92,832	(130,227)	4,799,577
Political subdivisions	4,055,000	108,752	-	4,163,752
Corporate securities	<u>342,978,679</u>	<u>23,475,428</u>	<u>(1,656,957)</u>	<u>364,797,150</u>
	<u>\$ 574,798,981</u>	<u>\$ 38,275,766</u>	<u>\$ (3,021,451)</u>	<u>\$ 610,053,296</u>

The carrying value and estimated fair value of bonds at December 31, 2011 and 2010, by contractual maturity, are as follows. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Statement Value	Estimated Fair Value
Less than one year	\$ 14,892,279	\$ 15,085,743
One year through five years	229,955,383	244,279,681
Six years through ten years	212,696,331	225,753,983
After ten years	<u>143,583,811</u>	<u>152,432,239</u>
	<u>\$ 601,127,804</u>	<u>\$ 637,551,646</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Long-Term Bonds, continued

Proceeds from sales and maturities of bonds during 2011 and 2010 were \$289,814,808 and \$129,764,583, respectively. Gross gains of \$21,601,354 and \$5,489,977, and gross losses of \$997,141 and \$565,492 were realized on those sales in 2011 and 2010, respectively.

Common Stocks

Gross unrealized capital gains and losses on common stocks are included in policyholder surplus as follows:

	<u>2011</u>	<u>2010</u>
Cost	\$ 38,593,607	\$ 21,560,259
Gross unrealized capital gains	6,829,391	7,525,592
Gross unrealized capital losses	<u>(1,943,238)</u>	<u>(3,305,629)</u>
Net unrealized capital gain	<u>4,886,153</u>	<u>4,219,963</u>
Fair value	\$ <u>43,479,760</u>	\$ <u>25,780,222</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment

The following table illustrates the gross unrealized losses and fair value of investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment type and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2011 and 2010:

	December 31, 2011					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Agency mortgage-backed	\$ 4,450,290	\$ (70,377)	\$ -	\$ -	\$ 4,450,290	\$ (70,377)
Commercial mortgage-backed	274,952	(51)	-	-	274,952	(51)
Commercial asset-backed	3,358,692	(52,312)	1,207,213	(96,942)	4,565,905	(149,254)
Other corporate bonds	20,556,765	(691,407)	987,420	(16,206)	21,544,185	(707,613)
Equity securities	<u>6,366,893</u>	<u>(776,493)</u>	<u>2,516,785</u>	<u>(1,166,745)</u>	<u>8,883,678</u>	<u>(1,943,238)</u>
Total	<u>\$ 35,007,592</u>	<u>\$ (1,590,640)</u>	<u>\$ 4,711,418</u>	<u>\$ (1,279,893)</u>	<u>\$ 39,719,010</u>	<u>\$ (2,870,533)</u>

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

	December 31, 2010					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S.						
government	\$ 15,051,200	\$ (877,852)	\$ -	\$ -	\$ 15,051,200	\$ (877,852)
State						
government	1,055,222	(109,731)	-	-	1,055,222	(109,731)
All other						
governments	2,846,280	(130,227)	-	-	2,846,280	(130,227)
Special						
revenue	5,853,240	(148,489)	-	-	5,853,240	(148,489)
Agency						
mortgage-						
backed	7,045,414	(98,197)	-	-	7,045,414	(98,197)
Commercial						
mortgage-						
backed	1,080,109	(18,125)	-	-	1,080,109	(18,125)
Other						
corporate						
bonds	45,671,695	(1,638,830)	-	-	45,671,695	(1,638,830)
Equity						
securities	<u>890,482</u>	<u>(64,023)</u>	<u>4,962,083</u>	<u>(3,241,606)</u>	<u>5,852,565</u>	<u>(3,305,629)</u>
Total	<u>\$ 79,493,642</u>	<u>\$ (3,085,474)</u>	<u>\$ 4,962,083</u>	<u>\$ (3,241,606)</u>	<u>\$ 84,455,725</u>	<u>\$ (6,327,080)</u>

KEMI evaluates impairment at each reporting period for each of the securities (other than loan-backed or structured securities) whereby the fair value of the investment is less than its amortized cost. It is expected that the securities would not be settled at a price less than the amortized cost of the investment, as KEMI has the ability and intent to hold the investment until there is not an unrealized loss on the investment. KEMI evaluated the credit ratings of these holdings, noting neither a significant deterioration since purchase nor other factors which may indicate an other-than-temporary impairment, such as the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and KEMI's intent and ability to hold the investment for a sufficient time in order to enable recovery of cost. KEMI continually monitors risk related to sub-prime investments. The current impact on the portfolio of sub-prime investments is minimal.

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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

KEMI's third party investment manager evaluated each loan-backed and structured security for impairment where the fair value of the investment was less than its amortized cost. For those securities that KEMI does intend to sell or does not have the ability to hold the security until recovery, an impairment is recorded equal to the difference of amortized cost and fair value. For all other loan-backed and structured securities, KEMI's asset manager used a proprietary model for loss assumptions and widely accepted models for prepayment assumptions in valuing mortgage-backed and asset-backed securities with inputs from major third party data providers. It combined the effects of interest rates, volatility, and prepayment speeds based on Monte Carlo simulation with credit loss analysis and resulting effective analytics (spreads, duration, convexity). Model assumptions were specific to asset class and collateral types and were regularly evaluated and adjusted where appropriate.

KEMI continues to review its investment portfolio under its impairment review policy. Given the current market conditions and the significant judgment involved, there is a continuing risk that further declines in fair value may occur and additional other than temporary impairments may be recorded in future periods.

4. Fair Value Measurements

The following table presents the carrying value and estimated fair value of KEMI's significant financial instruments at December 31, 2011 and 2010:

	<u>2011</u>		<u>2010</u>	
	<u>Carrying Value</u>	<u>Estimated Fair Value</u>	<u>Carrying Value</u>	<u>Estimated Fair Value</u>
Cash and short-term investments	\$ 25,116,986	\$ 25,116,986	\$ 13,609,705	\$ 13,609,705
U.S. treasury securities	41,687,740	43,179,575	55,662,266	58,062,017
U.S. agency mortgage-backed securities	33,267,341	35,406,336	38,346,796	41,851,820
U.S. special revenue bonds	148,465,949	156,638,936	126,754,869	134,313,008
Commercial mortgage-backed securities	31,966,678	33,623,301	26,116,220	27,256,975
Commercial asset-backed securities	34,844,125	35,837,748	26,577,599	27,246,488
Other corporate bonds	302,917,435	324,552,523	290,284,860	310,293,687
All other bonds	7,978,536	8,313,227	11,056,371	11,029,301
Equity securities	<u>43,479,760</u>	<u>43,479,760</u>	<u>25,780,222</u>	<u>25,780,222</u>
Total	<u>\$ 669,724,550</u>	<u>\$ 706,148,392</u>	<u>\$ 614,188,908</u>	<u>\$ 649,443,223</u>

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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2011 and 2010. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these statutory financial statements since that date, and current estimates of fair value may differ significantly from the amounts presented herein.

The following methods and assumptions were used to estimate the fair value of each significant class of financial instruments for which it is practical to estimate that value:

Cash and short-term investments: Valued at cost. The carrying amounts reported in the statements of admitted assets, liabilities and policyholder surplus approximate their fair value due to their short maturity.

Bonds, loan-backed and structured securities, and common stocks: Valued at fair value by the market and a third party portfolio manager. Fair values are based on values published by the SVO, quoted market prices, or dealer quotes. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services, or in the case of private placements, are estimated by discounting the expected future cash flows using current market rates applicable to the yield, credit, and maturity of the investment.

KEMI's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to fair values determined using unadjusted quote prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to fair values determined using unobservable inputs (Level 3). An asset's or liability's classification is determined based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that KEMI has the ability to access at the measurement date.

Level 2 – Valuations derived from inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as:

- a) Quoted prices for similar assets or liabilities in active markets.
- b) Quoted prices for identical or similar assets or liabilities in markets that are not active.
- c) Inputs other than quoted prices that are observable for the asset or liability.

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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Valuations are derived from techniques that require significant unobservable inputs. The unobservable inputs reflect KEMI's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

KEMI holds common stocks that are measured at fair value on a recurring basis. In addition, KEMI sometimes holds certain financial assets, primarily certain bonds valued at the lower of cost or fair value in accordance with NAIC reporting guidelines and assets that are impaired during the current reporting period and carried at fair value, that are considered to be measured at fair value on a recurring basis. The following table summarizes KEMI's assets and liabilities measured at fair value on a recurring basis as follows:

	<u>Fair Value Measurements at Reporting Date Using</u>			
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2011				
Investments:				
Common stock	\$ <u>43,479,760</u>	\$ <u>43,479,760</u>	\$ <u>-</u>	\$ <u>-</u>

	<u>Fair Value Measurements at Reporting Date Using</u>			
	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2010				
Investments:				
Common stock	\$ <u>25,780,222</u>	\$ <u>25,780,222</u>	\$ <u>-</u>	\$ <u>-</u>

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Notes to the Statutory Basis Financial Statements, continued

5. Losses and Loss Adjustment Expenses

As of December 31, 2011 and 2010, the following table provides a reconciliation of the beginning and ending reserve balances for losses and loss adjustment expenses (LAE):

	<u>2011</u>	<u>2010</u>
Gross reserves for losses and LAE - beginning of year	\$ 501,761,330	\$ 481,616,627
Less reinsurance recoverables	<u>77,847,798</u>	<u>92,202,905</u>
Net reserves for losses and LAE - beginning of year	423,913,532	389,413,722
Provision for claims, related to:		
Current year	101,549,702	89,244,715
Prior years	<u>12,593,583</u>	<u>7,303,455</u>
Total incurred	114,143,285	96,548,170
Payments for claims, related to:		
Current year	(30,851,843)	(26,318,661)
Prior years	<u>(30,619,418)</u>	<u>(35,729,699)</u>
Total paid	<u>(61,471,261)</u>	<u>(62,048,360)</u>
Net reserves for losses and LAE - end of year	476,585,556	423,913,532
Plus reinsurance recoverables	<u>62,114,683</u>	<u>77,847,798</u>
Gross reserves for losses and LAE - end of year	\$ <u>538,700,239</u>	\$ <u>501,761,330</u>

As a result of changes in estimates of insured events in prior years, the liability for unpaid losses and loss adjustment expenses (net of reinsurance recoverables) increased by \$12,593,583 and \$7,303,455 in 2011 and 2010, respectively. Anticipated subrogation recoverable on unpaid losses was \$3,500,000 as of December 31, 2011 and 2010.

KEMI's objective is to establish reported and unreported loss reserves that are adequate to cover all loss costs, while sustaining minimal variation from the date that the reserves are initially established until losses are fully developed. KEMI's prior year reserves developed unfavorably in both 2011 and 2010. In 2011, the development primarily related to recording of reserves related to the Byrd Amendment, which stemmed from the PPACA. In 2010, the development consists of net changes on prior accident year reserves based on regularly scheduled reviews, claims settling for more or less than reserved, emergence of unrecorded claims at rates different than reserved, changes in reserve estimates by claims representatives, medical cost inflation, and legislative changes impacting workers' compensation benefits and damage awards.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance

KEMI limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with various reinsurers under excess of loss and quota share agreements. These agreements cede premium on an earned basis. Ceded reinsurance is treated as the risk and liability of the assuming companies; however, these reinsurance contracts do not relieve KEMI from its original obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to KEMI; consequently, allowances are established for amounts deemed uncollectible. KEMI evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

KEMI maintains Excess of Loss reinsurance coverage with unaffiliated reinsurers for losses and loss adjustment expenses in excess of \$2.0 million per occurrence and up to \$75 million per occurrence. The Excess of Loss reinsurance agreements apply to KEMI's net retained liability, covering direct and assumed business in force as of each effective date, as well as business new or renewed from the effective date through the end of the contract term. Unpaid losses and loss adjustment expenses as of December 31, 2011 and 2010 included estimated reinsurance recoverables under the Excess of Loss agreements of \$62,114,683 and \$59,177,930, respectively.

For policy years 2006 through 2008, KEMI had 25% quota share reinsurance agreements with unaffiliated reinsurers (the Quota Share Agreements). The Quota Share Agreements applied to KEMI's net retained liability, covering businesses in-force as of each contract's effective date, as well as business new or renewed from the effective date to the following January 1. Under each of these contracts, KEMI was entitled to a provisional ceding commission of 18%. The Quota Share Agreements contained a loss ratio cap of 120% of premium ceded. Unpaid losses and loss adjustment expenses as of December 31, 2010 included estimated reinsurance recoverables under the Quota Share Agreements of \$18,669,868. There were no reinsurance recoverables related to the Quota Share Agreements as of December 31, 2011.

On January 1, 2011 and 2010, KEMI commuted its quota share reinsurance agreements with unaffiliated reinsurers which were in effect for 2008 and 2007 policies, respectively. KEMI increased its loss and loss adjustment expense reserves and reduced the related funds withheld balance by \$18,669,868 and \$13,311,160 in 2011 and 2010, respectively, to recognize the effect of releasing the reinsurers from their obligations under those treaties. There was no income statement effect from these commutations.

Effective April 1, 2011, KEMI engaged in an assumptive reinsurance arrangement with Zurich American Insurance Company through which KEMI offers multi-state coverage to its policyholders. Under the agreement, Zurich writes certain policies for which KEMI assumes 100% of the business. This coverage is only available to Kentucky-based businesses that have similar operations in other states. KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2011 includes \$223,171 related to this agreement. Zurich requires KEMI to maintain a standby letter of credit in the amount of \$1,600,000. The letter of credit is collateralized by U.S. Treasury Bonds.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

Effective January 1, 2007 through March 31, 2011, KEMI engaged in an assumptive reinsurance arrangement with Argonaut Insurance Company through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Argonaut wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective March 31, 2011, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2011 and 2010 includes \$773,408 and \$537,381, respectively, related to this agreement. Argonaut requires KEMI to maintain a standby letter of credit in the amount of \$2,909,115. The letter of credit is collateralized by U.S. Treasury Bonds.

Effective January 1, 2001 through December 31, 2002, KEMI engaged in an assumptive reinsurance arrangement with Fireman's Fund through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Fireman's Fund wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective December 31, 2002, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2011 and 2010 includes \$829,472 and \$857,100, respectively, related to this agreement. Fireman's Fund requires KEMI to maintain standby letters of credit in the amount of \$1,250,000. The letters of credit are collateralized by U.S. Treasury Bonds.

KEMI reported a provision for reinsurance in the amount of \$186,692 and \$149,380 at December 31, 2011 and 2010, respectively. This provision represents net recoverables from unauthorized (foreign) reinsurers for losses, loss adjustment expenses, and unearned premiums in excess of reinsurer deposits and letters of credit. The provision for reinsurance also includes 20% of reinsurance receivables greater than 90 days past due or in dispute. None of KEMI's reinsurance receivables were overdue or in dispute at December 31, 2011 or 2010.

KEMI has the following unsecured net reinsurance recoverables outstanding for losses, paid and unpaid, including IBNR and LAE and unearned premium that individually exceeded 3% of policyholder surplus at December 31, 2011 and 2010:

Federal ID#:	Reinsurer:	<u>2011</u>	<u>2010</u>
AA-1120337	Aspen Insurance UK Limited	\$ 6,222,100	\$ 5,735,368
AA-1126435	Lloyd's Syndicate No. 435	17,422,474	18,129,469
AA-1128000	Lloyd's Syndicate No. 2000	6,194,127	6,444,380

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

A summary of reinsurance transactions for 2011 and 2010 is as follows:

	<u>2011</u>	<u>2010</u>
Written premiums:		
Direct	\$ 114,334,043	\$ 106,205,905
Assumed	3,318,177	1,352,137
Ceded	<u>(4,816,238)</u>	<u>(4,636,894)</u>
Net	<u>\$ 112,835,982</u>	<u>\$ 102,921,148</u>
Earned premiums:		
Direct	\$ 110,817,105	\$ 108,721,576
Assumed	2,371,745	1,380,473
Ceded	<u>(4,816,238)</u>	<u>(4,636,894)</u>
Net	<u>\$ 108,372,612</u>	<u>\$ 105,465,155</u>
Incurred losses and LAE:		
Direct	\$ 116,406,122	\$ 99,719,785
Assumed	1,748,195	707,864
Ceded	<u>(4,011,035)</u>	<u>(3,879,479)</u>
Net	<u>\$ 114,143,282</u>	<u>\$ 96,548,170</u>
Unearned premiums:		
Direct	\$ 52,812,545	\$ 49,454,229
Assumed	1,406,566	460,134
Ceded	<u>-</u>	<u>-</u>
Net	54,219,111	49,914,363
Adjustment for earned but unbilled premiums	<u>(2,875,000)</u>	<u>(2,872,724)</u>
Net	<u>\$ 51,344,111</u>	<u>\$ 47,041,639</u>

KEMI has evaluated its reinsurance arrangements and believe they appropriately transfer risk in accordance with SSAP No. 62, *Property and Casualty Reinsurance*, and have therefore accounted for them as prospective reinsurance.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

7. Leases

KEMI leases space for its main office under a noncancellable operating lease which expires December 31, 2020. KEMI has two options to extend the lease, each for an additional 60 months following its expiration. Rental expense under this lease was \$1,221,845 and \$1,218,048 for 2011 and 2010, respectively. KEMI also leases space for a satellite office under a noncancellable operating lease which expires May 31, 2017. Rental expense under this lease was \$109,409 and \$104,656 for 2011 and 2010, respectively. The following is a summary of future minimum rental commitments for these leases:

2012	\$ 1,112,305
2013	1,116,060
2014	1,116,060
2015	1,119,133
2016	1,121,328
Thereafter	<u>4,046,712</u>
	<u>\$ 9,631,598</u>

8. Policyholder Dividend

On March 25, 2010, KEMI's Board of Directors approved a special, one-time dividend payable to current and past policyholders in the amount of \$30.8 million. To be eligible, policyholders must have had a KEMI policy for at least six months from 1995 through 2008, must have had at least \$350 in earned premiums, must have had a total loss ratio of less than 75%, and must have been in existence on the date the dividend was approved. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status. As of December 31, 2011, approximately \$28.3 million of the dividend had been paid out to policyholders and approximately \$0.6 million had been recovered from bad debt.

9. Retirement Plans

Eligible KEMI employees participate in the Kentucky Employees Retirement System (KERS). KERS is a contributory defined benefit pension plan sponsored by Kentucky Retirement Systems. Employees hired prior to September 1, 2008 are required to contribute 5% of gross salary to KERS, while those hired on or after September 1, 2008 are required to contribute 6% of gross salary. Employers contribute at a rate determined by the Board of Kentucky Retirement Systems to maintain the financial soundness of KERS. The employer contribution rate, which may be adjusted annually based on the actuarial valuation of KERS, was 19.82% and 16.98% at December 31, 2011 and 2010, respectively. Total pension expense paid by KEMI during 2011 and 2010 was \$2,349,301 and \$1,793,122, respectively. As of June 30, 2011, the most recent actuarial valuation date, KERS's total actuarial liability was \$11,903,435,476 and the actuarial value of assets totaled \$4,237,734,592. The portion of this obligation and the related assets attributable to KEMI's employees is relatively insignificant in relation to the plan's totals.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

9. Retirement Plans, continued

Eligible KEMI employees may also participate in the Kentucky Deferred Compensation Plan, a defined contribution plan for which KEMI matches up to 50% of the first 6% of compensation deferred by employees. Total contributions made by KEMI were \$238,250 and \$235,510 in 2011 and 2010, respectively.

10. Federal Income Taxes

As described in Note 1, KEMI is a political subdivision of the Commonwealth and was created by legislation to serve as the insurer of last resort as well as a competitive force to stabilize the workers' compensation market in Kentucky. The Commonwealth provided KEMI's initial funding and continues to influence KEMI through Governor appointed board members and through the role of oversight. For these reasons, KEMI's management believes KEMI is a tax-exempt entity pursuant to Internal Revenue Code sections §115 and §501(c)(27) and therefore not subject to federal income taxes. Accordingly, the statutory basis financial statements do not include a provision for federal income taxes.

11. Contingencies

KEMI is involved in litigation and may become involved in potential litigation arising in the ordinary course of business. Additionally, KEMI may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope of originally contemplated policies. In the opinion of management, the effects, if any, of such litigation and published court decisions are not expected to be material to the statutory basis financial statements.

12. Statutory Requirements

Under the insurance regulations of the Commonwealth of Kentucky, the amount of dividends that KEMI may pay to its policyholders is limited to the excess of actuarially determined minimum policyholder surplus requirements. Actuarially determined minimum policyholder surplus takes into consideration the company's present liabilities as well as management's expectation of future business volumes, claims activity and investment performance. The Commonwealth of Kentucky's statutory minimum policyholder surplus requirement is \$1,500,000.

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**Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other
Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing
Standards***

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have audited the statutory basis financial statements of Kentucky Employers' Mutual Insurance (KEMI) as of and for the year ended December 31, 2011, and have issued our report thereon dated March 29, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of KEMI is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered KEMI's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of KEMI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of KEMI's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page 2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KEMI's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Board of Directors, the audit committee and management of KEMI, and the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink, reading "Dean Darter Allen Ford, PE". The signature is written in a cursive, flowing style.

March 29, 2012
Lexington, Kentucky

DEAN || DORTON || ALLEN || FORD_{PLLC}

Awareness Letter

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have been engaged by Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) to perform annual audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, of KEMI's statutory basis financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Laws and Regulations of the Commonwealth of Kentucky that are applicable to audits of statutory basis financial statements of insurance entities. Also, after completion of our audits, we expect that we will issue our report on the statutory basis financial statements of KEMI as to their conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky.

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.



March 29, 2012
Lexington, Kentucky

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Qualification Letter

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the statutory basis financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) for the year ended December 31, 2011, and have issued our report thereon dated March 29, 2012. In connection therewith, we advise you as follows:

- a) We are independent certified public accountants with respect to KEMI and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the Kentucky State Board of Accountancy.
- b) The firm member in charge of the engagement and the engagement manager, who are certified public accountants, have over 14 years and 6 years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most of whom have had experience in auditing insurance enterprises and are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c) We understand that KEMI intends to file its audited statutory basis financial statements and our report thereon with the Department of Insurance of the Commonwealth of Kentucky (the Department) and that the commissioner of the Department will be relying on that information in monitoring and regulating the statutory financial condition of KEMI.

While we understand that an objective of issuing a report on the statutory basis financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, KEMI and the Department should understand that the objective of an audit of statutory basis financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* is to form an opinion and issue a report on whether the statutory basis financial statements present fairly, in all material respects, the admitted assets, liabilities, policyholder surplus, results of operations and cash flows in conformity with accounting practices prescribed or permitted by the Department. Consequently, under auditing standards generally accepted in the United States of America, we have the responsibility, within the inherent limitations of the auditing process, to plan and

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 Lexington, KY 40507
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First Trust Centre
 200 South Fifth Street
 Suite 201 South
 Louisville, KY 40202
 502.589.6050 *phone*
 502.581.9016 *fax*

www.ddafcpa.com

perform our audit to obtain reasonable assurance about whether the statutory basis financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on statutory basis financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of KEMI to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of statutory basis financial statements in conformity with accounting practices prescribed or permitted by the Department.

The Department should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditors' report.

- d) We will retain the workpapers prepared in the conduct of our audit until the Department has filed a Report of Examination covering 2011, but not longer than seven years. After notification to KEMI, we will make the workpapers available for review by the Department at the offices of the insurer, at our office, at the Department or at any other reasonable place designated by the Department. Furthermore, in the conduct of the aforementioned periodic review by the Department, photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Department.
- e) The firm member in charge of the engagement has served in that capacity with respect to KEMI for four years, is licensed by the Kentucky State Board of Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.
- f) To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page 3

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.

A handwritten signature in black ink, reading "Dean D. Allen, Esq.". The signature is written in a cursive style with a large, stylized "D" at the beginning and a clear "Esq." at the end.

March 29, 2012
Lexington, Kentucky

SUPPLEMENTARY INFORMATION

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement			
	1 Amount	2 Percentage	3 Amount	4 Securities Lending Reinvested Collateral Amount	5 Total (Col. 3 + 4) Amount	6 Percentage
1. Bonds:						
1.1 U.S. treasury securities.....	41,687,739	6.2	41,687,739		41,687,739	6.2
1.2 U.S. government agency obligations (excluding mortgage-backed securities):						
1.21 Issued by U.S. government agencies.....		0.0			0	0.0
1.22 Issued by U.S. government sponsored agencies.....	31,458,512	4.7	31,458,512		31,458,512	4.7
1.3 Non-U.S. government (including Canada, excluding mortgage-backed securities).....	2,646,129	0.4	2,646,129		2,646,129	0.4
1.4 Securities issued by states, territories and possessions and political subdivisions in the U.S.:						
1.41 States, territories and possessions general obligations.....	2,164,622	0.3	2,164,622		2,164,622	0.3
1.42 Political subdivisions of states, territories & possessions & political subdivisions general obligations.....	3,167,785	0.5	3,167,785		3,167,785	0.5
1.43 Revenue and assessment obligations.....	15,531,777	2.3	15,531,777		15,531,777	2.3
1.44 Industrial development and similar obligations.....		0.0			0	0.0
1.5 Mortgage-backed securities (includes residential and commercial MBS):						
1.51 Pass-through securities:						
1.511 Issued or guaranteed by GNMA.....	1,808,830	0.3	1,808,830		1,808,830	0.3
1.512 Issued or guaranteed by FNMA and FHLMC.....	112,457,258	16.8	112,457,258		112,457,258	16.8
1.513 All other.....		0.0			0	0.0
1.52 CMOs and REMICs:						
1.521 Issued or guaranteed by GNMA, FNMA, FHLMC or VA.....	20,476,908	3.1	20,476,908		20,476,908	3.1
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-backed securities issued or guaranteed by agencies shown in Line 1.521.....		0.0			0	0.0
1.523 All other.....	67,610,810	10.1	67,610,810		67,610,810	10.1
2. Other debt and other fixed income securities (excluding short-term):						
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities).....	243,227,576	36.3	243,227,576		243,227,576	36.3
2.2 Unaffiliated non-U.S. securities (including Canada).....	58,889,858	8.8	58,889,858		58,889,858	8.8
2.3 Affiliated securities.....		0.0			0	0.0
3. Equity interests:						
3.1 Investments in mutual funds.....		0.0			0	0.0
3.2 Preferred stocks:						
3.21 Affiliated.....		0.0			0	0.0
3.22 Unaffiliated.....		0.0			0	0.0
3.3 Publicly traded equity securities (excluding preferred stocks):						
3.31 Affiliated.....		0.0			0	0.0
3.32 Unaffiliated.....	43,479,760	6.5	43,479,760		43,479,760	6.5
3.4 Other equity securities:						
3.41 Affiliated.....		0.0			0	0.0
3.42 Unaffiliated.....		0.0			0	0.0
3.5 Other equity interests including tangible personal property under lease:						
3.51 Affiliated.....		0.0			0	0.0
3.52 Unaffiliated.....		0.0			0	0.0
4. Mortgage loans:						
4.1 Construction and land development.....		0.0			0	0.0
4.2 Agricultural.....		0.0			0	0.0
4.3 Single family residential properties.....		0.0			0	0.0
4.4 Multifamily residential properties.....		0.0			0	0.0
4.5 Commercial loans.....		0.0			0	0.0
4.6 Mezzanine real estate loans.....		0.0			0	0.0
5. Real estate investments:						
5.1 Property occupied by company.....		0.0			0	0.0
5.2 Property held for production of income (including \$.....0 of property acquired in satisfaction of debt).....		0.0			0	0.0
5.3 Property held for sale (including \$.....0 property acquired in satisfaction of debt).....		0.0			0	0.0
6. Contract loans.....		0.0			0	0.0
7. Derivatives.....		0.0			0	0.0
8. Receivables for securities.....		0.0			0	0.0
9. Securities lending (Line 10, Asset Page reinvested collateral).....		0.0		XXX	XXX	XXX
10. Cash, cash equivalents and short-term investments.....	25,116,986	3.8	25,116,986		25,116,986	3.8
11. Other invested assets.....		0.0			0	0.0
12. Total invested assets.....	669,724,551	100.0	669,724,551	0	669,724,551	100.0

See accompanying Independent Auditors' Report.



SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES

For the year ended December 31, 2011

(To be filed by April 1)

Of KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

Address (City, State, Zip Code): Lexington KY 40507-1724

NAIC Group Code.....0

NAIC Company Code.....10320

Employer's ID Number.....61-1275981

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on Page 2 of this annual statement. \$.....709,492,410

2. Ten largest exposures to a single issuer/borrower/investment.

1	2	3	4
Issuer	Description of Exposure	Amount	Percentage of Total Admitted Assets
2.01 Morgan Stanley.....	Long Term Bonds & Common Stock.....	\$.....12,848,212	.....1.811 %
2.02 Chase Issuance Trust.....	Long Term Bonds.....	\$.....6,578,179	.....0.927 %
2.03 General Electric Capital.....	Long Term Bonds & Common Stock.....	\$.....6,315,306	.....0.890 %
2.04 JP Morgan Chase & Co.....	Long Term Bonds & Common Stock.....	\$.....5,382,272	.....0.759 %
2.05 Citibank Credit Card Issuance Trust.....	Long Term Bonds.....	\$.....5,238,552	.....0.738 %
2.06 Johnson Controls Inc.....	Long Term Bonds & Common Stock.....	\$.....4,056,336	.....0.572 %
2.07 Fresno County CA.....	Long Term Bonds.....	\$.....4,028,885	.....0.568 %
2.08 AT&T Inc.....	Long Term Bonds & Common Stock.....	\$.....4,026,465	.....0.568 %
2.09 Chevron Corp.....	Long Term Bonds & Common Stock.....	\$.....3,702,159	.....0.522 %
2.10 Du Pont.....	Long Term Bonds & Common Stock.....	\$.....3,694,286	.....0.521 %

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

1	2
Bonds	
3.01 NAIC-1.....	\$.....533,624,132 .....75.212 %
3.02 NAIC-2.....	\$.....83,615,392 .....11.785 %
3.03 NAIC-3.....	\$.....0.000 %
3.04 NAIC-4.....	\$.....0.000 %
3.05 NAIC-5.....	\$.....0.000 %
3.06 NAIC-6.....	\$.....0.000 %
Preferred Stocks	
3.07 P/RP-1.....	\$.....0.000 %
3.08 P/RP-2.....	\$.....0.000 %
3.09 P/RP-3.....	\$.....0.000 %
3.10 P/RP-4.....	\$.....0.000 %
3.11 P/RP-5.....	\$.....0.000 %
3.12 P/RP-6.....	\$.....0.000 %

4. Assets held in foreign investments:

4.01 Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?

Yes [] No [X]

If response to 4.01 above is yes, responses are not required for interrogatories 5-10.

4.02 Total admitted assets held in foreign investments

\$.....49,487,1296.975 %

4.03 Foreign-currency-denominated investments

\$.....0.000 %

4.04 Insurance liabilities denominated in that same foreign currency

\$.....0.000 %

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:

1	2
5.01 Countries rated NAIC-1.....	\$.....44,014,217 .....6.204 %
5.02 Countries rated NAIC-2.....	\$.....5,472,912 .....0.771 %
5.03 Countries rated NAIC-3 or below.....	\$.....0.000 %

6. Largest foreign investment exposures by country, categorized by the country's NAIC sovereign rating:

1	2
Countries rated NAIC-1:	
6.01 Country 1: Australia.....	\$.....12,766,595 .....1.799 %
6.02 Country 2: United Kingdom.....	\$.....7,415,651 .....1.045 %
Countries rated NAIC-2:	
6.03 Country 1: Mexico.....	\$.....2,997,481 .....0.422 %
6.04 Country 2: Ireland.....	\$.....2,475,430 .....0.349 %
Countries rated NAIC-3 or below:	
6.05 Country 1:	\$.....0.000 %
6.06 Country 2:	\$.....0.000 %

7. Aggregate unhedged foreign currency exposure:

\$.....0.000 %

8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign rating:

1	2
8.01 Countries rated NAIC-1.....	\$.....0.000 %
8.02 Countries rated NAIC-2.....	\$.....0.000 %
8.03 Countries rated NAIC-3 or below.....	\$.....0.000 %

9. Largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign rating:
- | | 1 | 2 |
|----------------------------------|---------|--------------|
| Countries rated NAIC-1: | | |
| 9.01 Country 1: | \$..... |0.000 % |
| 9.02 Country 2: | \$..... |0.000 % |
| Countries rated NAIC-2: | | |
| 9.03 Country 1: | \$..... |0.000 % |
| 9.04 Country 2: | \$..... |0.000 % |
| Countries rated NAIC-3 or below: | | |
| 9.05 Country 1: | \$..... |0.000 % |
| 9.06 Country 2: | \$..... |0.000 % |
10. Ten largest non-sovereign (i.e. non-governmental) foreign issues:
- | | 1
Issuer | 2
NAIC Rating | 3 | 4 |
|--|-------------|------------------|------------------|--------------|
| 10.01 Statoil ASA..... | 1..... | | \$.....3,038,741 |0.428 % |
| 10.02 America Movil SAB De CV..... | 1..... | | \$.....2,997,481 |0.422 % |
| 10.03 BHP Billiton Finance..... | 1..... | | \$.....2,995,185 |0.422 % |
| 10.04 Shell International Finance..... | 1..... | | \$.....2,991,607 |0.422 % |
| 10.05 Korea Gas Corp..... | 1..... | | \$.....2,978,465 |0.420 % |
| 10.06 Schlumberger Investment..... | 1..... | | \$.....2,009,953 |0.283 % |
| 10.07 Hyundai Capital..... | 2..... | | \$.....2,001,554 |0.282 % |
| 10.08 Westpac Banking Corp..... | 1..... | | \$.....1,998,773 |0.282 % |
| 10.09 Deutsche Bank London..... | 1..... | | \$.....1,997,686 |0.282 % |
| 10.10 Banque PSA Finance..... | 2..... | | \$.....1,995,849 |0.281 % |
11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure:
- 11.01 Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets? Yes ☒ No ☐
- If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11.
- 11.02 Total admitted assets held in Canadian Investments \$.....0.000 %
- 11.03 Canadian currency-denominated investments \$.....0.000 %
- 11.04 Canadian-denominated insurance liabilities \$.....0.000 %
- 11.05 Unhedged Canadian currency exposure \$.....0.000 %
12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.
- 12.01 Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets? Yes ☒ No ☐
- If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.
- | | 1 | 2 | 3 |
|---|---|---------|--------------|
| 12.02 Aggregate statement value of investments with contractual sales restrictions: | | \$..... |0.000 % |
| Largest three investments with contractual sales restrictions: | | | |
| 12.03 | | \$..... |0.000 % |
| 12.04 | | \$..... |0.000 % |
| 12.05 | | \$..... |0.000 % |
13. Amounts and percentages of admitted assets held in the ten largest equity interests:
- 13.01 Are assets held in equity interest less than 2.5% of the reporting entity's total admitted assets? Yes ☐ No ☒
- If response to 13.01 above is yes, responses are not required for the remainder of Interrogatory 13.
- | | 1
Name of Issuer | 2 | 3 |
|---------------------------------|---------------------|------------------|--------------|
| 13.02 General Electric..... | | \$.....1,302,213 |0.184 % |
| 13.03 Pfizer Inc..... | | \$.....1,030,407 |0.145 % |
| 13.04 Microsoft..... | | \$.....1,014,915 |0.143 % |
| 13.05 Exxon Mobil..... | | \$.....965,796 |0.136 % |
| 13.06 Intel Corp..... | | \$.....806,079 |0.114 % |
| 13.07 Health Care REIT Inc..... | | \$.....756,836 |0.107 % |
| 13.08 Bank of America..... | | \$.....750,944 |0.106 % |
| 13.09 Duke Energy..... | | \$.....735,729 |0.104 % |
| 13.10 AT&T Inc..... | | \$.....713,333 |0.101 % |
| 13.11 ConocoPhillips..... | | \$.....712,474 |0.100 % |
14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:
- 14.01 Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets? Yes ☒ No ☐
- If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.
- | | 1 | 2 | 3 |
|--|---|---------|--------------|
| 14.02 Aggregate statement value of investments held in nonaffiliated, privately placed equities: | | \$..... |0.000 % |
| Largest three investments held in nonaffiliated, privately placed equities: | | | |
| 14.03 | | \$..... |0.000 % |
| 14.04 | | \$..... |0.000 % |
| 14.05 | | \$..... |0.000 % |
15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:
- 15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets? Yes ☒ No ☐
- If response to 15.01 above is yes, responses are not required for the remainder of Interrogatory 15.
- | | 1 | 2 | 3 |
|---|---|---------|--------------|
| 15.02 Aggregate statement value of investments held in general partnership interests: | | \$..... |0.000 % |
| Largest three investments in general partnership interests: | | | |
| 15.03 | | \$..... |0.000 % |
| 15.04 | | \$..... |0.000 % |
| 15.05 | | \$..... |0.000 % |

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

	1	2	3
Type (Residential, Commercial, Agricultural)			
16.02 .....	\$.....	.....0.000 %	
16.03 .....	\$.....	.....0.000 %	
16.04 .....	\$.....	.....0.000 %	
16.05 .....	\$.....	.....0.000 %	
16.06 .....	\$.....	.....0.000 %	
16.07 .....	\$.....	.....0.000 %	
16.08 .....	\$.....	.....0.000 %	
16.09 .....	\$.....	.....0.000 %	
16.10 .....	\$.....	.....0.000 %	
16.11 .....	\$.....	.....0.000 %	

Amount and percentage of the reporting entity's total admitted assets held in the following categories of mortgage loans:

	Loans
16.12 Construction loans.....	\$.....0.000 %
16.13 Mortgage loans over 90 days past due.....	\$.....0.000 %
16.14 Mortgage loans in the process of foreclosure.....	\$.....0.000 %
16.15 Mortgage loans foreclosed.....	\$.....0.000 %
16.16 Restructured mortgage loans.....	\$.....0.000 %

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

Statement Code	Loan-to-Value	Residential		Commercial		Agricultural	
		1	2	3	4	5	6
17.01	above 95%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.02	91% to 95%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.03	81% to 90%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.04	71% to 80%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %
17.05	below 70%.....	\$.....	0.000 %	\$.....	0.000 %	\$.....	0.000 %

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

18.01 Are assets held in real estate reported less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

Largest five investments in any one parcel or group of contiguous parcels of real estate.

Description	2	3
18.02 .....	\$.....	.....0.000 %
18.03 .....	\$.....	.....0.000 %
18.04 .....	\$.....	.....0.000 %
18.05 .....	\$.....	.....0.000 %
18.06 .....	\$.....	.....0.000 %

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans.

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the reporting entity's admitted assets?

Yes [X] No []

If response to 19.01 is yes, responses are not required for the remainder of Interrogatory 19.

	1	2	3
19.02 Aggregate statement value of investments held in mezzanine real estate loans:		\$.....	.....0.000 %
Largest three investments held in mezzanine real estate loans.			
19.03 .....	\$.....	.....0.000 %	
19.04 .....	\$.....	.....0.000 %	
19.05 .....	\$.....	.....0.000 %	

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	At Year-End		At End of Each Quarter		
	1	2	1st Qtr 3	2nd Qtr 4	3rd Qtr 5
20.01 Securities lending agreements (do not include assets held as collateral for such transactions).....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.02 Repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.03 Reverse repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.04 Dollar repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....
20.05 Dollar reverse repurchase agreements.....	\$.....	0.000 %	\$.....	\$.....	\$.....

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps and floors:

	Owned		Written	
	1	2	3	4
21.01 Hedging.....	\$.....	.....0.000 %	\$.....	.....0.000 %
21.02 Income generation.....	\$.....	.....0.000 %	\$.....	.....0.000 %
21.03 Other.....	\$.....	.....0.000 %	\$.....	.....0.000 %

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

	At Year-End		At End of Each Quarter		
	1	2	1st Qtr 3	2nd Qtr 4	3rd Qtr 5
22.01 Hedging.....	\$.....	0.000 %	\$.....	\$.....	\$.....
22.02 Income generation.....	\$.....	0.000 %	\$.....	\$.....	\$.....
22.03 Replications.....	\$.....	0.000 %	\$.....	\$.....	\$.....
22.04 Other.....	\$.....	0.000 %	\$.....	\$.....	\$.....

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

	<u>At Year-End</u>		<u>At End of Each Quarter</u>		
	1	2	1st Qtr 3	2nd Qtr 4	3rd Qtr 5
23.01 Hedging.....	\$.....	0.000 %	\$.....	\$.....	\$.....
23.02 Income generation.....	\$.....	0.000 %	\$.....	\$.....	\$.....
23.03 Replications.....	\$.....	0.000 %	\$.....	\$.....	\$.....
23.04 Other.....	\$.....	0.000 %	\$.....	\$.....	\$.....

See accompanying Independent Auditors' Report.

**KENTUCKY EMPLOYERS' MUTUAL
INSURANCE AUTHORITY dba KENTUCKY
EMPLOYERS' MUTUAL INSURANCE
Statutory Basis Financial Statements and
Supplementary Information**

*Years Ended December 31, 2010 and 2009
with Independent Auditors' Report Thereon*

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DEAN || DORTON || ALLEN || FORD

Independent Auditors' Report

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

We have audited the accompanying statutory basis statement of admitted assets, liabilities and policyholder surplus of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) as of December 31, 2010 and the related statutory basis statements of income, changes in policyholder surplus, and cash flows for the year then ended. These statutory basis financial statements are the responsibility of KEMI's management. Our responsibility is to express an opinion on these statutory basis financial statements based on our audit. The statutory basis financial statements of KEMI as of and for the year ended December 31, 2009, were audited by Dean Dorton Ford, PSC, whose report dated April 20, 2010, expressed an opinion that KEMI's 2009 statutory basis financial statements presented fairly, in all material respects, the admitted assets, liabilities and policyholder surplus of KEMI as of December 31, 2009, and the results of its operations and its cash flows for the year then ended on the basis of accounting prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky, whose practices differ from accounting principles generally accepted in the United States of America.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statutory basis financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statutory basis financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described more fully in Note 2 to the statutory basis financial statements, KEMI prepared these statutory basis financial statements using accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky, which practices differ from generally accepted accounting principles. The effects on the statutory basis financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page Two

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory basis financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance as of December 31, 2010, or the results of its operations or its cash flows for the year then ended.

In our opinion, the statutory basis financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and policyholder surplus of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance as of December 31, 2010, and the results of its operations and its cash flows for the year then ended, on the basis of accounting described in Note 2.

In accordance with *Government Auditing Standards*, we have also issued our report dated April 11, 2011 on our consideration of KEMI's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 - 8 and the supplementary information included in the accompanying Summary Investment Schedule and Supplemental Investment Risks Interrogatories are not a required part of the basic statutory basis financial statements but are supplementary information required by the Governmental Accounting Standards Board and statutory accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

A handwritten signature in dark ink, reading "Dean Dotson Allen Ford". The signature is written in a cursive, flowing style.

April 11, 2011
Lexington, Kentucky

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2010 MANAGEMENT'S DISCUSSION AND ANALYSIS

OBJECTIVE AND BACKGROUND

This discussion provides an assessment by management of the current financial position, results of operations, cash flow and liquidity of Kentucky Employers' Mutual Insurance Authority (KEMI, or the Company). Information presented in this discussion supplements KEMI's 2010 audited statutory basis financial statements, as well as the schedules and exhibits included in KEMI's 2010 Annual Statement filed with the Department of Insurance of the Commonwealth of Kentucky.

KEMI is a unique entity in the Kentucky workers' compensation insurance marketplace. KEMI operates as a self-supporting, competitive state fund created for the purpose of providing both a market of last resort for employers in the Commonwealth, as well as furnishing another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage. KEMI performs its duties under authority granted directly to it by the Kentucky General Assembly. Except for items specifically addressed in its enabling statute, KEMI operates as a domestic mutual insurance company. KEMI began writing business effective September 1, 1995.

KEMI is governed by a ten member board of directors. Seven board members are appointed by the Governor and three board members are specified cabinet secretaries. The board is responsible for hiring a manager, and both the board and the manager are given specific statutory duties.

The Company has set about to apply fiscal responsibility to the administration of workers' compensation insurance by keeping the cost of coverage affordable to all employers in the Commonwealth through increased competition and superior service. The Company allows each policyholder to control its own destiny in the marketplace. KEMI has no public funding and sets its standards based on long-term financial stability. KEMI does, in fact, make workers' comp work.

FINANCIAL POSITION

The Statement of Admitted Assets, Liabilities and Policyholder Surplus reflects KEMI's financial position at year end. KEMI's condensed Statements of Admitted Assets, Liabilities and Policyholder Surplus (balance sheets) as of December 31 were as follows:

	<u>2010</u>	<u>2009</u>
Admitted Assets:		
Long-term bonds and common stocks	\$ 600,579,203	\$ 589,523,073
Cash and short-term investments	13,609,705	9,507,852
Premium balances	32,564,939	42,264,215
Other assets	<u>6,559,048</u>	<u>6,873,681</u>
 Total assets	 \$ <u>653,312,895</u>	 \$ <u>648,168,821</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2010 MANAGEMENT'S DISCUSSION AND ANALYSIS

	<u>2010</u>	<u>2009</u>
Liabilities and Policyholder Surplus:		
Unpaid losses and loss adjustment expenses	\$ 423,913,532	\$ 389,413,722
Unearned premiums	49,914,363	53,836,849
Funds held by Company under reinsurance treaties	18,677,001	36,047,966
Policyholder dividends payable	2,351,136	0
Other liabilities	<u>14,776,566</u>	<u>14,872,404</u>
Total liabilities	509,632,598	494,170,941
Policyholder surplus	<u>143,680,297</u>	<u>153,997,880</u>
 Total liabilities and policyholder surplus	 \$ <u>653,312,895</u>	 \$ <u>648,168,821</u>

During 2010, KEMI's policyholder surplus decreased by \$10,317,583. Items that positively affected surplus were net investment income of \$26,900,775, net realized capital gains of \$4,963,199, net unrealized capital gains of \$2,842,889 and a decrease in non-admitted assets of \$4,907,387. These positives were offset by a net underwriting loss of \$15,098,550, policyholder dividends of \$30,800,011, non-admitted premium balances written off to bad debt expense of \$3,913,342 (net of \$537,159 in balances recovered and \$1,680 in fees for non-sufficient funds) and an increase in the statutory provision for reinsurance of \$119,930.

Assets

Net cash flows from operations amounted to \$26,644,397 for 2010 versus \$72,787,896 for 2009. This decrease was primarily due to policyholder dividend payments and declining premium levels. Despite these obstacles, KEMI's total cash and invested assets grew by \$15,157,983, or 2.53%. Net cash placed in the investment portfolio was \$3,577,801 during 2010. Investment grade bonds are stated at amortized cost while non-investment grade bonds, if any, are stated at the lower of amortized cost or fair market value. At the end of 2010, the total book value of KEMI's long-term bonds was \$574,798,981. The bond portfolio had an effective duration of 4.97 years, an average book yield of 4.81% and an average credit rating of Aa2/AA-. Common stocks, which are stated at fair market value as determined by the Securities Valuation Office of the NAIC, totaled \$25,780,222 and reflected a net unrealized gain of \$4,219,963 at the end of 2010. Cash and short-term investments, which are stated at fair market value, totaled \$13,609,705. The fair market value of KEMI's total cash and invested assets was \$649,443,223.

Investments with an unrealized loss are evaluated on a case by case basis to determine whether the decline in value is potentially permanent. If management deems a security to be permanently impaired, KEMI recognizes an Other Than Temporary Impairment (OTTI) realized loss on that security. In order to maintain a high quality portfolio, it is KEMI's practice to dispose of any security with an OTTI write-down. At the end of 2010, KEMI had no investments nearing OTTI status.

As a result of payment plan arrangements that KEMI offers to its policyholders, \$25,824,152 of the \$32,564,939 in premium balances reflected on the 2010 balance sheet were recorded, but the billings have been deferred and are not yet due. In addition, Statutory Accounting Principles require management to estimate the amount of premium that will be earned but unbilled at the end of each policy in force based upon past policy audit experience. Management's estimate of \$2,738,684 is included in KEMI's premium balances.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2010 MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-admitted assets are those assets which, under Statutory Accounting Principles, must be excluded from the balance sheet by a direct charge to surplus. At the end of 2010, KEMI's non-admitted assets totaled \$9,970,986, down from \$14,878,373 at the end of 2009. The bulk of KEMI's non-admitted assets, or \$8,438,361, is comprised of premium balances more than 90 days past due. The collectibility of these receivables is regularly assessed and written off to bad debt only after all efforts to secure payment have been exhausted. During 2010, uncollectible premium balances of \$4,452,181 were written off to bad debt expense. Other non-admitted assets are furniture, equipment and application software of \$745,710, prepaid expenses of \$235,000 and other receivables of \$551,915.

Liabilities

Reserves for unpaid losses and loss adjustment expenses are stated at the Company's estimate of the ultimate cost, net of ceded reinsurance, of settling all incurred but unpaid claims. Unpaid loss and loss adjustment expense reserves are based upon Company history and industry statistics, along with management's loss expectations based upon current premium levels. The method for making such estimates and for establishing the resulting liability is continually reviewed and any adjustments are reflected in the period determined. KEMI's reserves for unpaid losses and loss adjustment expenses are not discounted. Management believes that its loss reserving methodologies are conservative and that the Company's reserves are adequate. KEMI's reserves are evaluated annually by an independent third party actuary who provides a Statement of Actuarial Opinion to KEMI's independent auditors and to regulatory agencies. KEMI received an Unqualified Statement of Actuarial Opinion for 2010, as it has every year since its inception.

Activity with respect to losses and loss adjustment expenses, net of the effects of reinsurance, is displayed below:

	<u>2010</u>	<u>2009</u>
Unpaid losses and loss adjustment expenses, January 1	\$ 389,413,722	\$ 347,654,755
Losses and loss adjustment expenses incurred:		
Losses	77,269,017	81,214,207
Loss adjustment expenses	<u>19,279,153</u>	<u>18,657,499</u>
Total incurred	<u>96,548,170</u>	<u>99,871,706</u>
Losses and loss adjustment expenses paid:		
Losses	44,594,444	41,756,107
Loss adjustment expenses	<u>17,453,916</u>	<u>16,356,632</u>
Total paid	<u>62,048,360</u>	<u>58,112,739</u>
Unpaid losses and loss adjustment expenses, December 31	\$ <u>423,913,532</u>	\$ <u>389,413,722</u>

Adjustments made in 2010 and 2009 to the reserves for unpaid losses and loss adjustment expenses of prior accident years resulted in net increases to the reserves totaling of \$7,303,455 and \$7,144,010, respectively. These adjustments were charged to expense as losses and loss adjustment expenses incurred.

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY 2010 MANAGEMENT'S DISCUSSION AND ANALYSIS

At the end of 2010, KEMI had 4,499 open claims from direct business and 19 open claims from business assumed under the Company's multi-state program. Approximately 48% of these open claims occurred during 2010.

Policyholder Dividend

On March 25, 2010, KEMI's Board of Directors approved a special, one-time dividend payable to current and past policyholders in the amount of \$30.8 million. To be eligible to receive a dividend payment, policyholders must have had a KEMI policy for at least six months from 1995 through 2008, must have had at least \$350 in earned premiums, must have had a total loss ratio of less than 75%, and must have been in existence on the date the dividend was approved. KEMI's Board authorized management to recover from any dividend payable those amounts written off to bad debt and those amounts in outstanding collections status.

Policyholder Surplus

KEMI's net financial position remained strong in 2010. The decline in surplus of \$10,317,583, or 6.7%, was due to the special policyholder dividend declared in 2010. Management regularly reviews premium levels, expenditures and investment performance to maintain the Company's sound financial footing. Looking forward modest increases to surplus are expected, primarily from net investment income. As the economy recovers, the Company expects to see a slight gain in direct written premiums due to increasing policyholder payrolls. Losses, loss adjustment expenses and overall operating expenses are expected to remain relatively flat.

KEMI continues to monitor its leverage position as it relates to premium and loss reserve volume compared to surplus levels. The Company calculates its Risk Based Capital requirement annually in accordance with NAIC regulations. KEMI's surplus for 2010 was well within established guidelines.

RESULTS OF OPERATIONS

The Statement of Income measures the results of operations during the reporting period. KEMI's condensed Statements of Income for the years ended December 31 were as follows:

	<u>2010</u>	<u>2009</u>
Premiums earned	\$ 105,465,155	\$ 113,668,183
Losses and loss adjustment expenses incurred	96,548,170	99,871,706
Other underwriting expenses	<u>24,015,535</u>	<u>18,164,223</u>
Underwriting loss	(15,098,550)	(4,367,746)
Net investment income	26,900,775	25,908,895
Net realized capital gains (losses)	4,963,199	(3,546,306)
Other expenses	<u>(3,913,342)</u>	<u>(1,861,854)</u>
Net operating gain	12,852,082	16,132,989
Policyholder dividends	<u>(30,800,011)</u>	<u>0</u>
Net (loss) income after policyholder dividends	\$ <u>(17,947,929)</u>	\$ <u>16,132,989</u>

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY
2010 MANAGEMENT'S DISCUSSION AND ANALYSIS

KEMI's direct written premiums were \$106,205,905 for 2010, reflecting a 14.3% decrease from 2009. This decrease in direct written premiums is attributed to a struggling economy, to soft (extremely competitive) market conditions, and to KEMI's mission of making workers' compensation coverage affordable by adhering to financially responsible underwriting practices. KEMI's last rating action was a reduction of 6.0% to overall premium rates effective October 1, 2009.

CASH FLOW AND LIQUIDITY

Cash Flow

The Statement of Cash Flows reports cash provided and used by operations, investments, financing and miscellaneous activities during the reporting period. KEMI's condensed Statements of Cash Flows for the years ended December 31 were as follows:

	<u>2010</u>	<u>2009</u>
Cash Flows from Operations:		
Cash from underwriting activities	\$ 31,546,480	\$ 49,492,824
Investment income received	27,460,134	25,156,926
Policyholder dividend payments	(28,448,875)	0
Other operating expenses	<u>(3,913,342)</u>	<u>(1,861,854)</u>
Net cash provided from operations	<u>26,644,397</u>	<u>72,787,896</u>
Cash Flows from Investments:		
Proceeds from investments sold or matured	130,080,418	141,132,527
Cost of investments acquired	<u>(133,658,219)</u>	<u>(194,494,042)</u>
Net cash used for investments	<u>(3,577,801)</u>	<u>(53,361,515)</u>
Cash Flows from Miscellaneous Activities:		
Other cash applied	<u>(18,964,743)</u>	<u>(31,864,827)</u>
Net cash from miscellaneous activities	<u>(18,964,743)</u>	<u>(31,864,827)</u>
Net change in cash and short-term investments	4,101,853	(12,438,446)
Cash and short-term investments, beginning of year	<u>9,507,852</u>	<u>21,946,298</u>
Cash and short-term investments, end of year	\$ <u>13,609,705</u>	\$ <u>9,507,852</u>

Liquidity

KEMI invests policyholder premiums in assets whose maturities closely match the actuarial expected payout of the related losses and loss adjustment expenses. Funds available for investment, which exceed the estimated amounts required to eventually satisfy liabilities, are primarily invested in long-term bonds. KEMI maintains a very liquid bond portfolio with an effective duration of 4.97 years, and KEMI's equity positions are all actively traded on major exchanges. KEMI has sufficient cash resources available to meet its liabilities as they come due.

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2010 MANAGEMENT'S DISCUSSION AND ANALYSIS

***NOTE:** To the extent that the above comments constitute forward-looking statements, these statements are not guarantees of future performance. Forward-looking statements are based on current expectations and projections about future events and are subject to risks, uncertainties and assumptions about the Company, economic and market factors, judicial rulings and the insurance industry, among other things. Actual events and results may differ materially from those expressed in forward-looking statements.*

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Statements of Admitted Assets, Liabilities and Policyholder Surplus - Statutory Basis

December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Admitted Assets		
Long-term bonds	\$ 574,798,981	\$ 566,498,050
Common stock	25,780,222	23,025,023
Cash and short-term investments	13,609,705	9,507,852
Investment income due and accrued	6,167,884	6,391,144
Premiums in course of collection	6,740,787	8,941,443
Premiums booked but deferred and not yet due	25,824,152	33,322,772
Reinsurance receivable on losses and loss adjustment expenses	327,749	269,521
Electronic data processing equipment at cost, less accumulated depreciation of \$3,084,377 and \$2,934,776 in 2010 and 2009, respectively	<u>63,415</u>	<u>213,016</u>
Total admitted assets	\$ <u>653,312,895</u>	\$ <u>648,168,821</u>
Liabilities and Policyholder Surplus		
Unpaid losses	\$ 389,945,274	\$ 357,270,702
Unpaid loss adjustment expenses	33,968,258	32,143,020
Commissions payable	3,484,526	4,265,729
Unearned premiums	49,914,363	53,836,849
Amounts withheld or retained for others	6,598,788	7,723,219
Reinsurance premiums paid in advance	(859,294)	(1,087,928)
Remittances and items not allocated	1,286,282	1,261,808
Funds withheld under reinsurance treaties	18,677,001	36,047,966
Policyholder dividend payable	2,351,136	-
Other liabilities	<u>4,266,264</u>	<u>2,709,576</u>
Total liabilities	509,632,598	494,170,941
Policyholder surplus	<u>143,680,297</u>	<u>153,997,880</u>
Total liabilities and policyholder surplus	\$ <u>653,312,895</u>	\$ <u>648,168,821</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Statements of Income - Statutory Basis

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Premiums earned:		
Direct	\$ 108,721,576	\$ 131,823,909
Assumed	1,380,473	2,546,758
Ceded	<u>(4,636,894)</u>	<u>(20,702,484)</u>
	105,465,155	113,668,183
Losses incurred:		
Direct	80,212,196	89,296,365
Assumed	572,230	1,390,163
Ceded	<u>(3,515,408)</u>	<u>(9,472,321)</u>
	77,269,018	81,214,207
Loss adjustment expenses	19,279,152	18,657,499
Commissions and brokerage fees	8,885,116	5,341,337
Other underwriting expenses	<u>15,130,419</u>	<u>12,822,886</u>
Total underwriting expenses	<u>120,563,705</u>	<u>118,035,929</u>
Net underwriting loss	(15,098,550)	(4,367,746)
Investment income, net of investment expenses of \$1,196,777 and \$1,131,514 in 2010 and 2009, respectively	26,900,775	25,908,895
Net realized capital gains (losses)	4,963,199	(3,546,306)
Bad debt and other expenses	<u>(3,913,342)</u>	<u>(1,861,854)</u>
Net income before policyholder dividend	12,852,082	16,132,989
Policyholder dividend	<u>30,800,011</u>	<u>-</u>
Net (loss) income	\$ <u>(17,947,929)</u>	\$ <u>16,132,989</u>

See accompanying notes.

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Statements of Changes in Policyholder Surplus - Statutory Basis

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Policyholder surplus, beginning of year	\$ 153,997,880	\$ 131,738,149
Net (loss) income	(17,947,929)	16,132,989
Change in net unrealized gains on investments	2,842,889	5,537,518
Change in non-admitted assets	4,907,387	618,674
Change in provision for reinsurance	<u>(119,930)</u>	<u>(29,450)</u>
Policyholder surplus, end of year	\$ <u>143,680,297</u>	\$ <u>153,997,880</u>

See accompanying notes.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Statements of Cash Flows - Statutory Basis

Years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Premiums collected, net of reinsurance	\$ 116,253,055	\$ 125,360,692
Investment income, net of investment expenses	27,460,134	25,156,926
Miscellaneous expenses	(3,913,342)	(1,861,854)
Benefit and loss related payments	(44,652,674)	(41,802,878)
Commissions, expenses paid and aggregate write-ins	(40,053,901)	(34,064,990)
Dividend paid to policyholders	<u>(28,448,875)</u>	<u>-</u>
Net cash provided by operating activities	26,644,397	72,787,896
Cash flows from investing activities:		
Proceeds from investments sold or matured	130,080,418	141,132,527
Cost of investments acquired	<u>(133,658,219)</u>	<u>(194,494,042)</u>
Net cash used in investing activities	(3,577,801)	(53,361,515)
Cash flows from miscellaneous activities:		
Other cash applied	<u>(18,964,743)</u>	<u>(31,864,827)</u>
Net change in cash and short-term investments	4,101,853	(12,438,446)
Cash and short-term investments, beginning of year	<u>9,507,852</u>	<u>21,946,298</u>
Cash and short-term investments, end of year	\$ <u>13,609,705</u>	\$ <u>9,507,852</u>

See accompanying notes.

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KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements

1. Description of Organization

Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) is a non-profit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). KEMI was established by legislation of the Commonwealth enacted April 4, 1994 to serve as a competitive state fund for the purpose of providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage as required by state law. KEMI began writing business effective September 1, 1995.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying statutory basis financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky (the Department). The Department recognizes only statutory accounting practices prescribed or permitted by the Commonwealth of Kentucky for determining the solvency under the Kentucky insurance law. The National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual* has been adopted as a component of prescribed or permitted practices by the Commonwealth of Kentucky. The Department has the right to permit other specific practices that deviate from the prescribed practices. However, KEMI does not employ any such practices.

These statutory accounting practices comprise a comprehensive basis of accounting other than accounting practices generally accepted in the United States of America (GAAP) and differ in some respects. Some of the more significant of these differences are as follows:

- a. Investments in bonds with an NAIC rating of 1 or 2 are carried at NAIC determined value or amortized cost, whereas bonds with a NAIC rating of 3 through 6 are assigned specific year-end values by the NAIC and are written down to Securities Valuation Office (SVO) assigned values (if less than amortized cost) by charging statutory policyholder surplus. Under GAAP, bonds are classified into three categories: held to maturity, available for sale, and trading. Bonds held to maturity are stated at amortized cost; bonds available for sale are stated at fair value and the resulting unrealized gains or losses, net of applicable income taxes, are charged or credited to policyholder surplus; and bonds held for trading are reported at fair value and the resulting unrealized gains and losses are reported in earnings, net of related taxes.

The fair value of investments on a statutory basis is determined by the SVO, whereas for GAAP, the fair value of investments is determined based on the expected exit price.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

For loan-backed and structured securities, if the company determines that a security is impaired and they intend to sell the security or no longer have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security shall be written down to fair value. For statutory purposes, if the company subsequently changes their assertion, and now believe they do not intend to sell the security and have the ability and intent to retain the investment for a period of time sufficient to recover the amortized cost, that security will continue to be carried at the lower of cost or market with any future decreases in fair value charged through operations until the security is disposed. For GAAP purposes, once the company alters their assertion, that security's amortized cost basis will not be decreased for future reductions in fair value unless an other than temporary impairment is determined to have occurred.

Also, for GAAP purposes, other-than-temporary impairment losses (related to non loan-backed and structured securities) related to debt securities are bifurcated between credit and non-credit, where for statutory purposes the total other-than-temporary impairment loss is reported in earnings.

b. Assets having economic value other than those that can be used to fulfill policyholder obligations are categorized as "nonadmitted assets" and are not permitted to be included in the statutory financial statements of admitted assets, liabilities, and policyholder surplus, whereas, for GAAP, these assets are recognized in the balance sheet. Included with nonadmitted assets are furniture, equipment and supplies, prepaid expenses, certain receivables and other items that do not meet statutory criteria for admitted assets.

c. Receivables over 90 days outstanding are not admitted to the statutory financial statements and charged to policyholder surplus, whereas, for GAAP, the company assesses the collectability of premiums receivable and any charge is to the income statement.

d. The statutory financial statements are presented net of the effects of reinsurance, whereas, for GAAP, the financial statements are presented gross of the effects of reinsurance.

e. Guaranty fund assessments are generally available for recoupment from policyholders and as such, amounts assessed are recorded as a recoverable asset. Under GAAP, these assessments against the company are expensed when incurred and subsequently recorded as revenue when collected from the policyholders. Assessments against the policyholders are shown as a liability.

f. Commissions allowed by reinsurers on business ceded are reported as income when received rather than being deferred and, to the extent recoverable, amortized with deferred policy acquisition costs, as required under GAAP.

g. Comprehensive income is not determined for statutory reporting purposes, whereas, for GAAP, such

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Basis of Presentation, continued

income is recognized.

h. Costs incurred in connection with acquiring new insurance business, including commissions, are charged against statutory earnings as such costs are incurred, while, under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective periods covered by the related policies.

i. A statutory liability has been established and charged to policyholder surplus for amounts due from unauthorized reinsurers in excess of letters of credit, funds held, and premiums payable. Under GAAP, no such liability is provided.

j. The statutory statement of cash flows differs in certain respects from the presentation required within GAAP literature, including the presentation of changes in cash and short-term investments instead of cash and cash equivalents.

k. Policyholder surplus notes are included in policyholder surplus for statutory purposes, but are considered liabilities for GAAP. Interest expense is not recognized for statutory purposes until it is approved by the state of domicile, whereas for GAAP, the interest is accrued annually.

l. The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements that KEMI files with the NAIC and the state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP reporting.

The effect of the differences between statutory accounting practices and accounting principles generally accepted in the United States of America has not been determined, but is presumed to be material.

Risks and Uncertainties

Certain risks and uncertainties are inherent to KEMI's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties are presented below and throughout the notes to the statutory financial statements.

Use of Estimates - The preparation of the statutory basis financial statements requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statutory basis financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of unpaid losses and loss adjustment expenses. In connection with the determination of this liability, management uses the methodology described in *Unpaid Losses and Loss Adjustment Expenses* later in this footnote. While management uses the best information available to estimate unpaid losses and loss adjustment expenses, future changes to the liability may be necessary based on claims experience and changing claims frequency and severity conditions, as well as changes in doctrines of legal liability and damage awards in Kentucky. The future changes will be charged or credited to expense when they occur.

Loss Reserves - KEMI estimates losses and loss adjustment expenses (LAE) based on the accumulation of case estimates and loss reports, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported claims and incidents. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Actual results could differ from these estimates.

Reinsurance - Reinsurance contracts do not relieve KEMI from its obligations to insureds. Failure of reinsurers to honor their obligations could result in losses to KEMI. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Management believes that any liability arising from this contingency would not be material to KEMI's financial position.

Investment Risk - KEMI is exposed to risks that issuers of securities owned by KEMI will default or that interest rates will change and cause a decrease in the value of its investments. With mortgage-backed securities, KEMI is exposed to credit risk and prepayment risk.

As interest rates decline, the velocity at which these securities pay down the principal will increase. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

KEMI maintains balances at financial institutions that exceed federally insured limits; however, it also utilizes repurchase agreements and money market funds to mitigate this risk. KEMI's management continually evaluates the financial stability of these financial institutions.

Since most of KEMI's investments consist of securities that are traded in the public securities markets, they are subject to risk related to fluctuations in overall market performance and are potentially subject to heightened levels of market risk attributable to issuer, industry, and geographic region concentrations. KEMI's investment portfolio is regularly reviewed and the extent of its diversification is considered in the context of statutory requirements and other risk management and performance objectives.

External Factors - KEMI is highly regulated by the state in which it is domiciled. Such regulations, among other things, limit the amount of dividends and impose restrictions on the amount and types of investments.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Risks and Uncertainties, continued

Risk-Based Capital - The NAIC has developed property-casualty risk-based capital (RBC) standards that relate an insurer's reported statutory capital and policyholder surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to protect KEMI from the various risks that it faces. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. KEMI continues to monitor its internal capital requirements and the NAIC's RBC requirements. KEMI has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that KEMI's capital levels are sufficient to support the level of risk inherent in its operations.

Investments

Investments, excluding residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies, are stated at values prescribed by the NAIC's Security Valuation Office (SVO), which generally are as follows:

Non loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method with bonds containing call provisions being amortized to the call or maturity date, whichever results in a lower asset value. Loan-backed bonds rated 1 and 2 by the NAIC are stated at amortized cost using the scientific (constant yield) interest method including anticipated prepayments. Bonds rated 3 through 6 are carried at fair value with the change run through policyholder surplus.

Investments in residential mortgage-backed securities not guaranteed by federal or federally sponsored agencies utilize a financial model commissioned by the NAIC to determine credits ratings, and ultimately the NAIC designation/rating. This financial model requires a two step process. KEMI first determines the initial rating designation based upon each security's amortized cost in relation to security specific prescribed break points. This initial rating designation determines whether the security will be stated at amortized cost or fair value, based on the same criteria noted in the preceding paragraph. (The lower the amortized cost relative to par, the higher the NAIC designation, and more likely the security will be carried at amortized cost.) If the security is to be carried at fair value, KEMI then determines the final rating designation based upon each security's fair value in relation to the same security specific prescribed break points used in the first step. If the security is to be carried at amortized cost, the final designation remains the same as what was determined in the first step. The final designation is used for RBC purposes as well as for NAIC designation disclosure purposes.

Investments in preferred stocks with an NAIC rating designation of 1 or 2 are stated at amortized cost; all other preferred stocks are stated at the lesser of amortized cost or fair value.

Investments in common stocks are stated at fair value with unrealized gains and losses being reported as a

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Investments, continued

separate component of unassigned policyholder surplus.

Realized gains or losses are determined on the specific-identification method. Investment income is recognized as earned, net of related investment expenses. Bond premiums and discounts are amortized by the scientific-yield method and are charged or credited to net investment income. For mortgage-backed securities, KEMI anticipates prepayments utilizing published data in applying interest income. In accounting for mortgage-backed securities, KEMI uses the prospective method.

The assessment of other-than-temporary impairments is performed on a case-by-case basis. Factors considered by management in determining whether an other-than-temporary impairment exists (in other than loan-backed or structured securities) include: the financial condition, business prospects and creditworthiness of the issuer, the length of time and extent to which fair value has been less than cost for equity securities or amortized cost for fixed income securities, and KEMI's intent and ability to retain such investments until the fair value recovers. If it is determined that the decline in fair market value is other than temporary, the carrying amount of the investment is written down to fair value as its new basis and the amount of the write-down is recorded as a realized loss.

For loan-backed or structured securities, factors considered by management in determining whether an other-than-temporary impairment exists include KEMI's stated intent to not sell, KEMI's ability to hold such investments until the fair value recovers, and the discounted cash flows of the security based on the yield at the date of acquisition. If KEMI intends to sell or if KEMI does not have the ability and intent to hold the security for a period of time sufficient to recover its amortized cost basis, an other-than-temporary impairment exists, and the security is written down to fair value with the amount of the write-down recorded as a realized loss. If KEMI does not intend to sell the security and has the ability and intent to hold the security for a period of time sufficient to recover the amortized cost basis, KEMI calculates the cash flows expected to be collected. In this calculation, KEMI compares the present value of cash flows expected to be collected, discounted at the security's effective interest rate at date of purchase, to the amortized cost basis. If the present value of cash flows is less than the amortized cost basis, a realized loss is recorded for the difference. The present value of cash flows then becomes the new cost basis.

KEMI uses the prospective method to accrete the amortized cost basis to the ultimate expected cash flows.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Premiums

Premiums are earned on the daily pro-rata method over the policy period and are stated after deduction for reinsurance. Unearned premiums represent the portion of initial premiums written that are applicable to the unexpired terms of policies in force. Initial premiums are recorded as premiums written on the policy effective date except for certain premiums that are recorded on an installment basis. Any subsequent additional premiums or refunds that occur as a result of policy audits are recorded as written premiums at the time the policy audits are finalized. Earned but unbilled premiums represent management's estimate of future audit premiums and are included in premiums booked but deferred and not yet due.

Premiums in course of collection which are customer obligations due under normal terms requiring payment by the policy due date, and premiums booked but deferred and not yet due are valued at their carrying amount, which approximates fair value. Receivables over 90 days outstanding are not admitted to the statutory financial statements.

Unpaid Losses and Loss Adjustment Expenses

The estimated liability for losses is based on the accumulation of case estimates for claims and incidents reported, net of applicable policy deductibles and deduction of amounts for reinsurance ceded on reported claims and incidents. Also included in the liability for losses are estimates of incurred but not reported losses based on historical experience adjusted for current trends. The liability for LAE is provided by estimating future expenses to be incurred in settlement of the claims provided for in the reserve for losses, net of reinsurance ceded. Estimates for loss and related LAE are made without regard to the time value of money.

Management believes that the provisions for losses and LAE are adequate to cover the net cost of claims incurred and incidents reported; however, the provisions are necessarily based upon estimates and, therefore, the ultimate liability may be less than or exceed such estimates. As adjustments become necessary in these estimates, such adjustments are reflected in the results of operations in the period in which they are determined.

The reserves for unpaid losses are net of anticipated subrogation.

Reinsurance

Reinsurance premiums, losses, and loss adjustment expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums, losses, and loss adjustment expenses are reported net of reinsured amounts. KEMI evaluates the financial condition of its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. KEMI holds funds and collateral as security under reinsurance agreements in the form of letters of credit for any reinsurers not subject to the regulation of the Kentucky Commissioner of Insurance. In the opinion of management, all amounts due from reinsurers at December 31, 2010 and 2009 are recoverable.

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Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Cash and Short-Term Investments

Cash and short-term investments consist of cash on deposit with financial institutions and investments with original maturities of less than one year at the date of acquisition. These investments are carried at cost, which approximates fair value. At December 31, 2010 and 2009, KEMI had substantially all of its cash on deposit with a bank, which is insured by the Federal Deposit Insurance Corporation up to the statutory limit of \$250,000. Collected balances in excess of \$100,000 per account are swept nightly into repurchase agreements collateralized at 102% by US government agency securities.

Concentrations of Geographic and Credit Risk

All of KEMI's total direct gross written premiums of \$106,205,905 for the year ended December 31, 2010 were for insureds in Kentucky.

The credit quality of the bond portfolio at December 31, 2010 is presented is as follows:

	<u>Carrying Value</u>	<u>Percentage</u>
Class 1 - highest quality	\$ 524,728,049	91.3 %
Class 2 - high quality	<u>50,070,932</u>	<u>8.7</u>
Total	\$ <u>574,798,981</u>	<u>100 %</u>

Bonds with ratings from AAA to BBB as assigned by Standard & Poor's Corporation are generally considered as investment grade securities. Some securities issued by the U.S. government or an agency thereof are not rated but are considered to be investment grade. The NAIC regards U.S. Treasuries and agencies and all A ratings as Class 1 (highest quality), BBB ratings as Class 2 (high quality), BB ratings as Class 3 (medium quality), B ratings as Class 4 (low quality), C ratings as Class 5 (lower quality), and D ratings as Class 6 (in or near default).

Reclassifications

Certain prior period amounts have been reclassified to conform to the current year financial statement presentation.

Newly Adopted Pronouncements

In 2009, the NAIC adopted SSAP No. 100, *Fair Value Measurements*. SSAP No. 100 defines fair value, establishes a framework for measuring fair value and establishes disclosure requirements about fair value. This statement is effective for December 31, 2010 annual statutory basis financial statements. KEMI adopted SSAP No. 100 with no material effect to the statutory basis financial statements.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

2. Summary of Significant Accounting Policies, continued

Property and Equipment

Electronic data processing equipment, including operating software, is stated at cost less accumulated depreciation. Depreciation expense on such property was \$149,601 and \$235,617 in 2010 and 2009, respectively. Furniture, office equipment, and application software are non-admitted assets under statutory accounting practices. Depreciation expense on such property was \$618,732 and \$582,807 in 2010 and 2009, respectively.

Depreciation expense is computed using the straight-line method over the estimated useful lives of the assets. Gains and losses on the sale of property and equipment are recorded in the year of disposition. Maintenance and repairs are expensed as incurred; replacements and betterments are capitalized.

Advertising

KEMI expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2010 and 2009, was \$1,009,606 and \$708,774, respectively.

Subsequent Events

Management has evaluated subsequent events for accounting and disclosure requirements through April 11, 2011, the date that the statutory basis financial statements were available to be issued. Except as disclosed in Note 13, there were no events occurring during the evaluation period that require recognition or disclosure in the statutory basis financial statements.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

3. Investments

Long-Term Bonds

The carrying value/adjusted cost, gross unrealized gains, gross unrealized losses, and the estimated fair value of investments in bonds are summarized as follows:

	Statement Value	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
As of December 31, 2010:				
U.S. government	\$ 94,009,062	\$ 6,782,626	\$ (877,851)	\$ 99,913,837
State government	2,164,399	11,304	(109,731)	2,065,972
All other governments	4,836,972	92,832	(130,227)	4,799,577
Political subdivisions	4,055,000	108,752	-	4,163,752
Special revenue	126,754,869	7,804,824	(246,685)	134,313,008
Corporate securities	<u>342,978,679</u>	<u>23,475,428</u>	<u>(1,656,957)</u>	<u>364,797,150</u>
	<u>\$ 574,798,981</u>	<u>\$ 38,275,766</u>	<u>\$ (3,021,451)</u>	<u>\$ 610,053,296</u>
As of December 31, 2009:				
U.S. government	\$ 91,340,954	\$ 4,938,396	\$ (453,874)	\$ 95,825,476
State government	999,231	30,989	-	1,030,220
All other governments	1,919,514	4,560	(8,667)	1,915,407
Political subdivisions	5,306,535	91,875	-	5,398,410
Special revenue	139,817,803	5,978,406	(311,604)	145,484,605
Corporate securities	<u>327,114,013</u>	<u>14,815,950</u>	<u>(2,045,463)</u>	<u>339,884,500</u>
	<u>\$ 566,498,050</u>	<u>\$ 25,860,176</u>	<u>\$ (2,819,608)</u>	<u>\$ 589,538,618</u>

Statement values in the foregoing table represent amortized cost, except for certain non-investment grade bonds that are required to be carried at the lower of amortized cost or fair value. During 2009, KEMI recognized other-than-temporary impairments on two corporate bonds and recorded realized losses of \$1,319,339, representing the difference between amortized cost of \$3,954,999 and fair value of \$2,635,660. KEMI disposed of all bonds with other-than-temporary impairments in the latter half of 2009, resulting in a net realized gain of \$96,081 on the sale of these securities. No such impairments were recognized during 2010.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Long-Term Bonds, continued

The carrying value and estimated fair value of bonds at December 31, 2010 and 2009, by contractual maturity, are as follows. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Statement <u>Value</u>	Estimated Fair <u>Value</u>
Less than one year	\$ 8,758,940	\$ 8,930,197
One year through five years	226,762,317	241,361,956
Six years through ten years	224,614,052	239,039,239
After ten years	<u>114,663,672</u>	<u>120,721,904</u>
	<u>\$ 574,798,981</u>	<u>\$ 610,053,296</u>

The contractual maturities in the foregoing table may differ from the expected maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Proceeds from sales and maturities of bonds during 2010 and 2009 were \$129,764,583 and \$138,910,954, respectively. Gross gains of \$5,489,977 and \$2,359,707, and gross losses of \$565,492 and \$4,493,680 were realized on those sales in 2010 and 2009, respectively.

Common Stocks

Gross unrealized capital gains and losses on common stocks are included in policyholder surplus as follows:

	<u>2010</u>	<u>2009</u>
Cost	\$ 21,560,259	\$ 21,647,949
Gross unrealized capital gains	7,525,592	5,801,377
Gross unrealized capital losses	<u>(3,305,629)</u>	<u>(4,424,303)</u>
Net unrealized capital gain	<u>4,219,963</u>	<u>1,377,074</u>
Fair value	<u>\$ 25,780,222</u>	<u>\$ 23,025,023</u>

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment

The following table illustrates the gross unrealized losses and fair value of investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment type and length of time that individual securities have been in a continuous unrealized loss position, as of December 31, 2010 and 2009:

	December 31, 2010					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S.						
government	\$ 15,051,200	\$ (877,852)	\$ -	\$ -	\$ 15,051,200	\$ (877,852)
State						
government	1,055,222	(109,731)	-	-	1,055,222	(109,731)
All other						
governments	2,846,280	(130,227)	-	-	2,846,280	(130,227)
Special						
revenue	5,853,240	(148,489)	-	-	5,853,240	(148,489)
Agency						
mortgage-						
backed	7,045,414	(98,197)	-	-	7,045,414	(98,197)
Non-agency						
mortgage-						
backed	1,080,109	(18,125)	-	-	1,080,109	(18,125)
Other						
corporate						
bonds	45,671,695	(1,638,830)	-	-	45,671,695	(1,638,830)
Equity						
securities	<u>890,482</u>	<u>(64,023)</u>	<u>4,962,083</u>	<u>(3,241,606)</u>	<u>5,852,565</u>	<u>(3,305,629)</u>
Total	<u>\$ 79,493,642</u>	<u>\$ (3,085,474)</u>	<u>\$ 4,962,083</u>	<u>\$ (3,241,606)</u>	<u>\$ 84,455,725</u>	<u>\$ (6,327,080)</u>

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

	December 31, 2009					
	Less than 12 months		12 months or more		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S.						
government	\$ 18,881,181	\$ (453,874)	\$ -	\$ -	\$ 18,881,181	\$ (453,874)
All other governments	712,407	(8,667)	-	-	712,407	(8,667)
Special revenue	1,042,110	(2,223)	2,765,510	(237,171)	3,807,620	(239,394)
Agency mortgage-backed	5,571,919	(72,210)	-	-	5,571,919	(72,210)
Non-agency mortgage-backed	17,509,099	(101,722)	8,809,287	(988,135)	26,318,386	(1,089,857)
Other corporate bonds	43,057,526	(624,669)	6,959,980	(330,937)	50,017,506	(955,606)
Equity securities	<u>935,842</u>	<u>(140,330)</u>	<u>5,884,507</u>	<u>(4,283,973)</u>	<u>6,820,349</u>	<u>(4,424,303)</u>
Total	<u>\$ 87,710,084</u>	<u>\$ (1,403,695)</u>	<u>\$ 24,419,284</u>	<u>\$ (5,840,216)</u>	<u>\$ 112,129,368</u>	<u>\$ (7,243,911)</u>

KEMI evaluates impairment at each reporting period for each of the securities (other than loan-backed or structured securities) whereby the fair value of the investment is less than its amortized cost. It is expected that the securities would not be settled at a price less than the amortized cost of the investment, as KEMI has the ability and intent to hold the investment until there is not an unrealized loss on the investment. KEMI evaluated the credit ratings of these holdings, noting neither a significant deterioration since purchase nor other factors which may indicate an other-than-temporary impairment, such as the length of time and extent to which fair value has been less than cost, the financial condition and near-term prospects of the issuer as well as specific events or circumstances that may influence the operations of the issuer, and KEMI's intent and ability to hold the investment for a sufficient time in order to enable recovery of cost. KEMI continually monitors risk related to sub-prime investments. The current impact on the portfolio of sub-prime investments is minimal.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

3. Investments, continued

Other-Than-Temporary Impairment, continued

KEMI's third party investment manager evaluated each loan-backed and structured security for impairment where the fair value of the investment was less than its amortized cost. For those securities that KEMI does intend to sell or does not have the ability to hold the security until recovery, an impairment is recorded equal to the difference of amortized cost and fair value. For all other loan-backed and structured securities, KEMI's asset manager used a proprietary model for loss assumptions and widely accepted models for prepayment assumptions in valuing mortgage-backed and asset-backed securities with inputs from major third party data providers. It combined the effects of interest rates, volatility, and prepayment speeds based on Monte Carlo simulation with credit loss analysis and resulting effective analytics (spreads, duration, convexity). Model assumptions were specific to asset class and collateral types and were regularly evaluated and adjusted where appropriate.

KEMI continues to review its investment portfolio under its impairment review policy. Given the current market conditions and the significant judgment involved, there is a continuing risk that further declines in fair value may occur and additional other than temporary impairments may be recorded in future periods.

4. Fair Value Measurements

The following table presents the carrying value and estimated fair value of KEMI's significant financial instruments at December 31, 2010 and 2009:

	<u>2010</u>		<u>2009</u>	
	<u>Carrying Value</u>	<u>Estimated Fair Value</u>	<u>Carrying Value</u>	<u>Estimated Fair Value</u>
Cash and short-term investments	\$ 13,609,705	\$ 13,609,705	\$ 9,507,852	\$ 9,507,852
U.S. treasury securities	55,662,266	58,062,017	49,854,185	51,455,067
Agency mortgage-backed securities	149,083,467	159,673,403	164,863,699	173,315,956
Non-agency mortgage-backed securities	52,693,821	54,503,463	44,992,177	44,558,591
Other corporate bonds	290,284,864	310,293,691	282,121,842	295,325,912
All other bonds	27,074,563	27,520,722	24,666,147	24,883,092
Equity securities	25,780,222	25,780,222	23,025,023	23,025,023

The fair value estimates presented herein are based on pertinent information available to management as of December 31, 2010 and 2009. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these statutory financial statements since that date, and current estimates of fair value may differ significantly from the amounts presented herein.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

The following methods and assumptions were used to estimate the fair value of each significant class of financial instruments for which it is practical to estimate that value:

Cash and short-term investments: Valued at cost. The carrying amount reported in the statements of admitted assets, liabilities and policyholder surplus approximate their fair value due to their short maturity.

Bonds, loan-backed and structured securities, and common stocks: Valued at fair value by the market and a third party portfolio manager. Fair values are based on values published by the SVO, quoted market prices, or dealer quotes. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services, or in the case of private placements, are estimated by discounting the expected future cash flows using current market rates applicable to the yield, credit, and maturity of the investment.

KEMI's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The hierarchy gives the highest priority to fair values determined using unadjusted quote prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to fair values determined using unobservable inputs (Level 3). An asset's or liability's classification is determined based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

Level 1 – Unadjusted quoted prices in active markets for identical assets or liabilities that KEMI has the ability to access at the measurement date.

Level 2 – Valuations derived from inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, such as:

- a) Quoted prices for similar assets or liabilities in active markets.
- b) Quoted prices for identical or similar assets or liabilities in markets that are not active.
- c) Inputs other than quoted prices that are observable for the asset or liability.
- d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 – Valuations are derived from techniques that require significant unobservable inputs. The unobservable inputs reflect KEMI's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

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Notes to the Statutory Basis Financial Statements, continued

4. Fair Value Measurements, continued

KEMI holds common stocks that are measured at fair value on a recurring basis. In addition, KEMI sometimes holds certain financial assets, primarily certain bonds valued at the lower of cost or fair value in accordance with NAIC reporting guidelines and assets that are impaired during the current reporting period and carried at fair value, that are considered to be measured at fair value on a recurring basis. The following table summarizes KEMI's assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 and 2009:

	Fair Value	<u>Fair Value Measurements at Reporting Date Using</u> Quoted Prices		
		in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investments:				
Common stock	\$ <u>25,780,222</u>	\$ <u>25,780,222</u>	\$ <u>-</u>	\$ <u>-</u>
Total assets at fair value	\$ <u>25,780,222</u>	\$ <u>25,780,222</u>	\$ <u>-</u>	\$ <u>-</u>

The fair values of assets and liabilities at December 31, 2009 are summarized as follows:

	Fair Value	<u>Fair Value Measurements at Reporting Date Using</u> Quoted Prices		
		in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Investments:				
Common stock	\$ <u>23,025,023</u>	\$ <u>23,025,023</u>	\$ <u>-</u>	\$ <u>-</u>
Total assets at fair value	\$ <u>23,025,023</u>	\$ <u>23,025,023</u>	\$ <u>-</u>	\$ <u>-</u>

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Notes to the Statutory Basis Financial Statements, continued

5. Losses and Loss Adjustment Expenses

As of December 31, 2010 and 2009, the following table provides a reconciliation of the beginning and ending reserve balances for losses and loss adjustment expenses (LAE):

	<u>2010</u>	<u>2009</u>
Gross reserves for losses and LAE - beginning of year	\$ 481,616,627	\$ 454,589,805
Less reinsurance recoverables	<u>92,202,905</u>	<u>106,935,050</u>
Net reserves for losses and LAE - beginning of year	389,413,722	347,654,755
Provision for claims, related to:		
Current year	89,244,715	92,727,696
Prior years	<u>7,303,455</u>	<u>7,144,010</u>
Total incurred	96,548,170	99,871,706
Payments for claims, related to:		
Current year	(26,318,661)	(26,398,921)
Prior years	<u>(35,729,699)</u>	<u>(31,713,818)</u>
Total paid	<u>(62,048,360)</u>	<u>(58,112,739)</u>
Net reserves for losses and LAE - end of year	423,913,532	389,413,722
Plus reinsurance recoverables	<u>77,847,798</u>	<u>92,202,905</u>
Gross reserves for losses and LAE - end of year	\$ <u>501,761,330</u>	\$ <u>481,616,627</u>

As a result of changes in estimates of insured events in prior years, the liability for unpaid losses and loss adjustment expenses (net of reinsurance recoverables) increased by \$7,303,455 and \$7,144,010 in 2010 and 2009, respectively. Anticipated subrogation recoverable on unpaid losses was \$3,500,000 and \$3,000,000 as of December 31, 2010 and 2009, respectively.

KEMI's objective is to establish reported and unreported loss reserves that are adequate to cover all loss costs, while sustaining minimal variation from the date that the reserves are initially established until losses are fully developed. KEMI's prior year reserves developed unfavorably in both 2010 and 2009. Total development consists of net changes on prior accident year reserves based on regularly scheduled reviews, claims settling for more or less than reserved, emergence of unrecorded claims at rates different than reserved, and changes in reserve estimates by claims representatives.

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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance

KEMI limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with various reinsurers under excess of loss and quota share agreements. These agreements cede premium on an earned basis. Ceded reinsurance is treated as the risk and liability of the assuming companies; however, these reinsurance contracts do not relieve KEMI from its original obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to KEMI; consequently, allowances are established for amounts deemed uncollectible. KEMI evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies.

KEMI maintains Excess of Loss reinsurance coverage with unaffiliated reinsurers for losses and loss adjustment expenses in excess of \$1.5 million per occurrence and up to \$75 million per occurrence. The Excess of Loss reinsurance agreements apply to KEMI's net retained liability, covering direct and assumed business in force as of each effective date, as well as business new or renewed from the effective date through the end of the contract term. Unpaid losses and loss adjustment expenses as of December 31, 2010 and 2009 included estimated reinsurance recoverables under the Excess of Loss agreements of \$59,177,930 and \$56,162,075, respectively.

For policy years 2006 through 2008, KEMI had 25% quota share reinsurance agreements with unaffiliated reinsurers (the Quota Share Agreements). The Quota Share Agreements applied to KEMI's net retained liability, covering businesses in-force as of each contract's effective date, as well as business new or renewed from the effective date to the following January 1. Under each of these contracts, KEMI was entitled to a provisional ceding commission of 18%. The Quota Share Agreements contained a loss ratio cap of 120% of premium ceded. Unpaid losses and loss adjustment expenses as of December 31, 2010 and 2009 included estimated reinsurance recoverables under the Quota Share Agreements of \$18,669,868 and \$36,040,830, respectively.

On January 1, 2010 and 2009, KEMI commuted its quota share reinsurance agreements with unaffiliated reinsurers which were in effect for 2007 and 2006 policies, respectively. KEMI increased its loss and loss adjustment expense reserves and reduced the related funds withheld balance by \$13,311,160 and \$14,143,942 in 2010 and 2009, respectively, to recognize the effect of releasing the reinsurers from their obligations under these treaties. There was no income statement effect from these commutations.

Since January 1, 2007, KEMI has engaged in an assumptive reinsurance arrangement with Argonaut Insurance Company through which KEMI offers multi-state coverage to its policyholders. Under the agreement, Argonaut writes certain policies for which KEMI assumes 100% of the business. This coverage is only available to Kentucky-based businesses that have similar operations in other states. KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2010 and 2009 includes \$537,381 and \$717,088, respectively, related to this agreement. Argonaut requires KEMI to maintain a standby letter of credit in the amount of \$3,000,000. The letter of credit is collateralized by U.S. Treasury Bonds.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

Effective January 1, 2001 through December 31, 2002, KEMI engaged in an assumptive reinsurance arrangement with Fireman's Fund through which KEMI offered multi-state coverage to its policyholders. Under the agreement, Fireman's Fund wrote certain policies for which KEMI assumed 100% of the business. This coverage was only available to Kentucky-based businesses that had similar operations in other states. Although the agreement was terminated effective December 31, 2002, KEMI remains liable for losses and loss adjustment expenses incurred during the contract period. Accordingly, KEMI's liability for unpaid losses and loss adjustment expenses as of December 31, 2010 and 2009 includes \$857,100 and \$916,475, respectively, related to this agreement. Fireman's Fund requires KEMI to maintain standby letters of credit in the amount of \$1,250,000. The letters of credit are collateralized by U.S. Treasury Bonds.

KEMI reported a provision for reinsurance in the amount of \$149,380 and \$29,450 at December 31, 2010 and 2009, respectively. This provision represents net recoverables from unauthorized (foreign) reinsurers for losses, loss adjustment expenses, and unearned premiums in excess of reinsurer deposits and letters of credit. The provision for reinsurance also includes 20% of reinsurance receivables greater than 90 days past due or in dispute. None of KEMI's reinsurance receivables were overdue or in dispute at December 31, 2010 or 2009.

KEMI has the following unsecured net reinsurance recoverables outstanding for losses, paid and unpaid, including IBNR and LAE and unearned premium that individually exceeded 3% of policyholder surplus at December 31, 2010 and 2009:

Federal ID#:	Reinsurer:		<u>2010</u>		<u>2009</u>
AA-1120337	Aspen Insurance UK Limited	\$	5,735,368	\$	5,614,341
AA-1126435	Lloyd's Syndicate No. 435		18,129,469		17,840,711
AA-1128000	Lloyd's Syndicate No. 2000		6,444,380		6,544,327

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Notes to the Statutory Basis Financial Statements, continued

6. Reinsurance, continued

A summary of reinsurance transactions for 2010 and 2009 is as follows:

	<u>2010</u>	<u>2009</u>
Written premiums:		
Direct	\$ 106,205,905	\$ 123,879,548
Assumed	1,352,137	1,463,733
Ceded	<u>(4,636,894)</u>	<u>(5,803,966)</u>
Net	\$ <u>102,921,148</u>	\$ <u>119,539,315</u>
Earned premiums:		
Direct	\$ 108,721,576	\$ 131,823,909
Assumed	1,380,473	2,546,758
Ceded	<u>(4,636,894)</u>	<u>(20,702,484)</u>
Net	\$ <u>105,465,155</u>	\$ <u>113,668,183</u>
Incurred losses and LAE:		
Direct	\$ 99,719,785	\$ 108,539,455
Assumed	707,864	1,609,576
Ceded	<u>(3,879,479)</u>	<u>(10,277,325)</u>
Net	\$ <u>96,548,170</u>	\$ <u>99,871,706</u>
Unearned premiums:		
Direct	\$ 49,454,229	\$ 53,348,378
Assumed	460,134	488,471
Ceded	<u>-</u>	<u>-</u>
Net	49,914,363	53,836,849
Adjustment for earned but unbilled premiums	<u>(2,872,724)</u>	<u>(4,251,204)</u>
Net	\$ <u>47,041,639</u>	\$ <u>49,585,645</u>

KEMI has evaluated its reinsurance arrangements and believe they appropriately transfer risk in accordance with SSAP No. 62, *Property and Casualty Reinsurance*, and have therefore accounted for them as reinsurance.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
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Notes to the Statutory Basis Financial Statements, continued

7. Leases

KEMI leases space for its main office under a noncancellable operating lease which expires June 30, 2013. KEMI has two options to extend the lease, each for an additional 60 months following its expiration. Rental expense under this lease was \$1,218,048 and \$1,238,038 for 2010 and 2009, respectively. KEMI also leases space for a satellite office under a noncancellable operating lease which expires April 30, 2012. KEMI has an option to extend the lease for an additional 60 months following its expiration. Rental expense under this lease was \$104,656 and \$101,120 for 2010 and 2009, respectively. The following is a summary of future minimum rental commitments for these leases:

2011	\$ 1,180,176
2012	1,109,096
2013	<u>502,995</u>
	<u>\$ 2,792,267</u>

8. Policyholder Dividend

On March 25, 2010, KEMI's Board of Directors approved a special, one-time dividend payable to current and past policyholders in the amount of \$30.8 million. To be eligible policyholders must have had a KEMI policy for at least six months from 1995 through 2008, must have had at least \$350 in earned premiums, must have had a total loss ratio of less than 75%, and must have been in existence on the date the dividend was approved. The Board authorized management to recover from any dividend payable those amounts written off to bad debt or currently in outstanding collections status. As of December 31, 2010, approximately \$28.0 million of the dividend had been paid out to policyholders and approximately \$0.5 million had been recovered from bad debt.

9. Retirement Plans

KEMI employees participate in the Kentucky Employees Retirement System (KERS). KERS is a contributory defined benefit pension plan sponsored by Kentucky Retirement Systems. Employees hired prior to September 1, 2008 are required to contribute 5% of gross salary to KERS, while those hired on or after September 1, 2008 are required to contribute 6% of gross salary. Employers contribute at a rate determined by the Board of Kentucky Retirement Systems to maintain the financial soundness of KERS. The employer contribution rate, which may be adjusted annually based on the actuarial valuation of KERS, was 16.98% and 11.61% at December 31, 2010 and 2009, respectively. Total pension expense paid by KEMI during 2010 and 2009 was \$1,793,122 and \$1,301,605, respectively. As of June 30, 2010, the most recent actuarial valuation date, KERS's total actuarial liability was \$11,692,944,540 and the actuarial value of assets totaled \$4,712,944,594. The portion of this obligation and the related assets attributable to KEMI's employees is relatively insignificant in relation to the plan's totals.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

9. Retirement Plans, continued

Eligible KEMI employees may also participate in the Kentucky Deferred Compensation Plan, a defined contribution plan for which KEMI matches up to 50% of the first 6% of compensation deferred by eligible employees. Total contributions made by KEMI were \$235,510 and \$222,686 in 2010 and 2009, respectively.

10. Federal Income Taxes

As described in Note 1, KEMI is a political subdivision of the Commonwealth and was created by legislation to serve as the insurer of last resort as well as a competitive force to stabilize the workers' compensation market in Kentucky. The Commonwealth provided KEMI's initial funding and continues to influence KEMI through Governor appointed board members and through the role of oversight. For these reasons, KEMI's management believes KEMI is a tax-exempt entity pursuant to Internal Revenue Code sections §115 and §501(c)(27) and therefore not subject to federal income taxes. Accordingly, the statutory basis financial statements do not include a provision for federal income taxes.

11. Contingencies

KEMI is involved in litigation and may become involved in potential litigation arising in the ordinary course of business. Additionally, KEMI may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope of originally contemplated policies. In the opinion of management, the effects, if any, of such litigation and published court decisions are not expected to be material to the statutory basis financial statements.

12. Statutory Requirements

Under the insurance regulations of the Commonwealth of Kentucky, the amount of dividends that KEMI may pay to its policyholders is limited to the excess of actuarially determined minimum policyholder surplus requirements. Actuarially determined minimum policyholder surplus takes into consideration the company's present liabilities as well as management's expectation of future business volumes, claims activity and investment performance. The Commonwealth of Kentucky's statutory minimum policyholder surplus requirement is \$1,500,000.

13. Subsequent Events

All of the effects of subsequent events that provide additional evidence about conditions that existed at the statement of admitted assets, liabilities and policyholder surplus date, including the estimates inherent in the process of preparing the statutory basis financial statements, are recognized in the statutory basis financial statements. KEMI does not recognize subsequent events that provide evidence about conditions that did not exist at the statement of admitted assets, liabilities and policyholder surplus date but arose after, but before the statutory basis financial statements are available to be issued. In some cases, nonrecognized subsequent events are disclosed to keep the statutory basis financial statements from being misleading.

**KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY dba
KENTUCKY EMPLOYERS' MUTUAL INSURANCE**

Notes to the Statutory Basis Financial Statements, continued

13. Subsequent Events, continued

Effective January 1, 2011, KEMI commuted its quota share reinsurance agreement with unaffiliated reinsurers which was in effect for 2008 policies. KEMI increased its loss and loss adjustment expense reserves and reduced the related funds withheld balance by \$18,669,868 to recognize the effect of releasing the reinsurers from their obligations under these treaties.

DEAN || DORTON || ALLEN || FORD

**Report on Internal Control Over Financial Reporting and on
Compliance and Other Matters Based on an Audit of Financial
Statements Performed in Accordance With *Government Auditing Standards***

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have audited the statutory basis financial statements of Kentucky Employers' Mutual Insurance (KEMI) as of and for the year ended December 31, 2010, and have issued our report dated April 11, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered KEMI's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the statutory basis financial statements, but not for the purpose of expressing an opinion on the effectiveness of KEMI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of KEMI's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's statutory basis financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KEMI's statutory basis financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

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Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page Two

Compliance and Other Matters

As part of obtaining reasonable assurance about whether KEMI's statutory basis financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the Board of Directors, the audit committee and management of KEMI, and the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in dark ink, reading "Dean Dotson Allen Ford". The signature is written in a cursive, flowing style.

April 11, 2011
Lexington, Kentucky

DEAN || DORTON || ALLEN || FORD

Awareness Letter

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky

We have been engaged by Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) to perform annual audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, of KEMI's statutory basis financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Laws and Regulations of the Commonwealth of Kentucky that are applicable to audits of statutory basis financial statements of insurance entities. Also, after completion of our audits, we expect that we will issue our report on the statutory basis financial statements of KEMI as to their conformity with accounting practices prescribed or permitted by the Department of Insurance of the Commonwealth of Kentucky.

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.

Dean Dorton Allen Ford

April 11, 2011
Lexington, Kentucky

DEAN || DORTON || ALLEN || FORD

Qualification Letter

Board of Directors
 Kentucky Employers' Mutual Insurance Authority dba
 Kentucky Employers' Mutual Insurance
 Lexington, Kentucky

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the statutory basis financial statements of Kentucky Employers' Mutual Insurance Authority dba Kentucky Employers' Mutual Insurance (KEMI) for the year ended December 31, 2010, and have issued our report thereon dated April 11, 2011. In connection therewith, we advise you as follows:

- a) We are independent certified public accountants with respect to KEMI and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the Kentucky State Board of Accountancy.
- b) The firm member in charge of the engagement and the engagement manager, who are certified public accountants, have over 13 years and 5 years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most of whom have had experience in auditing insurance enterprises and are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c) We understand that KEMI intends to file its audited statutory basis financial statements and our report thereon with the Department of Insurance of the Commonwealth of Kentucky (the Department) and that the commissioner of the Department will be relying on that information in monitoring and regulating the statutory financial condition of KEMI.

While we understand that an objective of issuing a report on the statutory basis financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, KEMI and the Department should understand that the objective of an audit of statutory basis financial statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* is to form an opinion and issue a report on whether the statutory basis financial statements present fairly, in all material respects, the admitted assets, liabilities, policyholder surplus, results of operations and cash flows in conformity with accounting practices prescribed or permitted by the Department. Consequently, under auditing standards generally accepted in the United States of America, we have the responsibility, within the inherent limitations of the auditing process, to plan and

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plan and perform our audit to obtain reasonable assurance about whether the statutory basis financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on statutory basis financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of KEMI to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of statutory basis financial statements in conformity with accounting practices prescribed or permitted by the Department.

The Department should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditors' report.

- d) We will retain the workpapers prepared in the conduct of our audit until the Department has filed a Report of Examination covering 2010, but not longer than seven years. After notification to KEMI, we will make the workpapers available for review by the Department at the offices of the insurer, at our office, at the Department or at any other reasonable place designated by the Department. Furthermore, in the conduct of the aforementioned periodic review by the Department, photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Department.
- e) The firm member in charge of the engagement has served in that capacity with respect to KEMI for three years, is licensed by the Kentucky State Board of Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.
- f) To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

Board of Directors
Kentucky Employers' Mutual Insurance Authority dba
Kentucky Employers' Mutual Insurance
Lexington, Kentucky
Page Three

This letter is intended solely for the information and use of the Department of Insurance of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than this specified party.

A handwritten signature in dark ink that reads "Dean Dotson Allen Ford". The signature is written in a cursive, flowing style.

April 11, 2011
Lexington, Kentucky

SUPPLEMENTARY INFORMATION

KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

SUMMARY INVESTMENT SCHEDULE

Investment Categories	Gross Investment Holdings		Admitted Assets as Reported in the Annual Statement	
	1 Amount	2 Percentage	3 Amount	4 Percentage
1. Bonds:				
1.1 U.S. treasury securities.....	55,662,266	9.1	55,662,266	9.1
1.2 U.S. government agency obligations (excluding mortgage-backed securities):				
1.21 Issued by U.S. government agencies.....		0.0		0.0
1.22 Issued by U.S. government sponsored agencies.....	36,303,732	5.9	36,303,732	5.9
1.3 Non-U.S. government (including Canada, excluding mortgage-backed securities).....	4,836,972	0.8	4,836,972	0.8
1.4 Securities issued by states, territories and possessions and political subdivisions in the U.S.:				
1.41 States, territories and possessions general obligations.....	2,164,399	0.4	2,164,399	0.4
1.42 Political subdivisions of states, territories & possessions & political subdivisions general obligations.....	4,055,000	0.7	4,055,000	0.7
1.43 Revenue and assessment obligations.....	15,626,499	2.5	15,626,499	2.5
1.44 Industrial development and similar obligations.....		0.0		0.0
1.5 Mortgage-backed securities (includes residential and commercial MBS):				
1.51 Pass-through securities:				
1.511 Issued or guaranteed by GNMA.....	2,434,761	0.4	2,434,761	0.4
1.512 Issued or guaranteed by FNMA and FHLMC.....	78,547,950	12.8	78,547,950	12.8
1.513 All other.....		0.0		0.0
1.52 CMOs and REMICs:				
1.521 Issued or guaranteed by GNMA, FNMA, FHLMC or VA.....	32,188,726	5.2	32,188,726	5.2
1.522 Issued by non-U.S. Government issuers and collateralized by mortgage-backed securities issued or guaranteed by agencies shown in Line 1.521.....		0.0		0.0
1.523 All other.....	52,693,821	8.6	52,693,821	8.6
2. Other debt and other fixed income securities (excluding short-term):				
2.1 Unaffiliated domestic securities (includes credit tenant loans and hybrid securities).....	234,288,298	38.1	234,288,298	38.1
2.2 Unaffiliated non-U.S. securities (including Canada).....	55,996,557	9.1	55,996,557	9.1
2.3 Affiliated securities.....		0.0		0.0
3. Equity interests:				
3.1 Investments in mutual funds.....		0.0		0.0
3.2 Preferred stocks:				
3.21 Affiliated.....		0.0		0.0
3.22 Unaffiliated.....		0.0		0.0
3.3 Publicly traded equity securities (excluding preferred stocks):				
3.31 Affiliated.....		0.0		0.0
3.32 Unaffiliated.....	25,780,222	4.2	25,780,222	4.2
3.4 Other equity securities:				
3.41 Affiliated.....		0.0		0.0
3.42 Unaffiliated.....	0	0.0		0.0
3.5 Other equity interests including tangible personal property under lease:				
3.51 Affiliated.....		0.0		0.0
3.52 Unaffiliated.....		0.0		0.0
4. Mortgage loans:				
4.1 Construction and land development.....		0.0		0.0
4.2 Agricultural.....		0.0		0.0
4.3 Single family residential properties.....		0.0		0.0
4.4 Multifamily residential properties.....		0.0		0.0
4.5 Commercial loans.....		0.0		0.0
4.6 Mezzanine real estate loans.....		0.0		0.0
5. Real estate investments:				
5.1 Property occupied by company.....		0.0		0.0
5.2 Property held for production of income (including \$.....0 of property acquired in satisfaction of debt).....		0.0		0.0
5.3 Property held for sale (including \$.....0 property acquired in satisfaction of debt).....		0.0		0.0
6. Contract loans.....		0.0		0.0
7. Receivables for securities.....		0.0		0.0
8. Cash, cash equivalents and short-term investments.....	13,609,705	2.2	13,609,705	2.2
9. Other invested assets.....		0.0		0.0
10. Total invested assets.....	614,188,908	100.0	614,188,908	100.0

**SUPPLEMENTAL INVESTMENT RISKS INTERROGATORIES**

For the year ended December 31, 2010

(To be filed by April 1)

Of KENTUCKY EMPLOYERS' MUTUAL INSURANCE AUTHORITY

Address (City, State, Zip Code): Lexington KY 40507-1724

NAIC Group Code.....0

NAIC Company Code.....10320

Employer's ID Number.....61-1275981

The Investment Risks Interrogatories are to be filed by April 1. They are also to be included with the Audited Statutory Financial Statements.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

1. Reporting entity's total admitted assets as reported on Page 2 of this annual statement. \$.....653,312,896

2. Ten largest exposures to a single issuer/borrower/investment.

1	2	3	4
			Percentage of Total
<u>Issuer</u>	<u>Description of Exposure</u>	<u>Amount</u>	<u>Admitted Assets</u>
2.01 Morgan Stanley.....	Long Term Bonds & Common Stock.....	\$.....11,241,012	.....1.721 %
2.02 Lehman Brothers.....	Long Term Bonds.....	\$.....7,965,804	.....1.219 %
2.03 General Electric Capital.....	Long Term Bonds & Common Stock.....	\$.....5,890,112	.....0.902 %
2.04 Bear Stearns.....	Long Term Bonds.....	\$.....4,993,281	.....0.764 %
2.05 Chase Issuance Trust.....	Long Term Bonds.....	\$.....4,515,507	.....0.691 %
2.06 Fresno County CA.....	Long Term Bonds.....	\$.....4,046,206	.....0.619 %
2.07 IBM Corp.....	Long Term Bonds & Common Stock.....	\$.....3,624,974	.....0.555 %
2.08 Merck & Co.....	Long Term Bonds & Common Stock.....	\$.....3,329,230	.....0.510 %
2.09 Cisco Systems.....	Long Term Bonds & Common Stock.....	\$.....3,265,121	.....0.500 %
2.10 Goldman Sachs.....	Long Term Bonds & Common Stock.....	\$.....3,211,939	.....0.492 %

3. Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

	1	2
<u>Bonds</u>		
3.01 NAIC-1.....	\$.....527,498,533	.....80.742 %
3.02 NAIC-2.....	\$.....50,070,932	.....7.664 %
3.03 NAIC-3.....	\$.....	.....0.000 %
3.04 NAIC-4.....	\$.....	.....0.000 %
3.05 NAIC-5.....	\$.....	.....0.000 %
3.06 NAIC-6.....	\$.....	.....0.000 %
<u>Preferred Stocks</u>	3	4
3.07 P/RP-1.....	\$.....	.....0.000 %
3.08 P/RP-2.....	\$.....	.....0.000 %
3.09 P/RP-3.....	\$.....	.....0.000 %
3.10 P/RP-4.....	\$.....	.....0.000 %
3.11 P/RP-5.....	\$.....	.....0.000 %
3.12 P/RP-6.....	\$.....	.....0.000 %

4. Assets held in foreign investments:

4.01 Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets?	Yes []	No [X]
If response to 4.01 above is yes, responses are not required for interrogatories 5-10.		
4.02 Total admitted assets held in foreign investments	\$.....51,274,729	.....7.848 %
4.03 Foreign-currency-denominated investments	\$.....	.....0.000 %
4.04 Insurance liabilities denominated in that same foreign currency	\$.....	.....0.000 %

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:

	1	2
5.01 Countries rated NAIC-1.....	\$.....48,277,965	.....7.390 %
5.02 Countries rated NAIC-2.....	\$.....2,996,764	.....0.459 %
5.03 Countries rated NAIC-3 or below.....	\$.....	.....0.000 %

6. Largest foreign investment exposures by country, categorized by the country's NAIC sovereign rating:

	1	2
Countries rated NAIC-1:		
6.01 Country 1: United Kingdom.....	\$.....12,342,010	.....1.889 %
6.02 Country 2: Australia.....	\$.....10,760,104	.....1.647 %
Countries rated NAIC-2:		
6.03 Country 1: Mexico.....	\$.....2,996,764	.....0.459 %
6.04 Country 2: .....	\$.....	.....0.000 %
Countries rated NAIC-3 or below:		
6.05 Country 1: .....	\$.....	.....0.000 %
6.06 Country 2: .....	\$.....	.....0.000 %

7. Aggregate unhedged foreign currency exposure:

1	2
\$.....	.....0.000 %

8. Aggregate unhedged foreign currency exposure categorized by NAIC sovereign rating:

	1	2
8.01 Countries rated NAIC-1.....	\$.....	.....0.000 %
8.02 Countries rated NAIC-2.....	\$.....	.....0.000 %
8.03 Countries rated NAIC-3 or below.....	\$.....	.....0.000 %

9. Largest unhedged foreign currency exposures by country, categorized by the country's NAIC sovereign rating:

	1	2
Countries rated NAIC-1:		
9.01 Country 1: .....	\$.....	.....0.000 %
9.02 Country 2: .....	\$.....	.....0.000 %
Countries rated NAIC-2:		
9.03 Country 1: .....	\$.....	.....0.000 %
9.04 Country 2: .....	\$.....	.....0.000 %
Countries rated NAIC-3 or below:		
9.05 Country 1: .....	\$.....	.....0.000 %
9.06 Country 2: .....	\$.....	.....0.000 %

10. Ten largest non-sovereign (i.e. non-governmental) foreign issues:

Unlisted non sovereign (i.e. non-governmental) foreign issues:				
	1	2		
	Issuer	NAIC Rating	3	4
10.01	France Telecom.....	1FE.....	\$.....3,554,179	.....0.544 %
10.02	Statoil ASA.....	1FE.....	\$.....3,043,056	.....0.466 %
10.03	Santander US Debt SA Uni.....	1FE.....	\$.....3,024,104	.....0.463 %
10.04	America Movil SAB de CV.....	1FE.....	\$.....2,996,764	.....0.459 %
10.05	Deutsche Bank AG London.....	1FE.....	\$.....2,995,536	.....0.459 %
10.06	BHP Billiton Finance.....	1FE.....	\$.....2,993,227	.....0.458 %
10.07	Shell International Finance.....	1FE.....	\$.....2,990,710	.....0.458 %
10.08	Iberdrola Finance Ireland.....	1FE.....	\$.....2,988,384	.....0.457 %
10.09	Korea Gas Corp.....	1FE.....	\$.....2,976,507	.....0.456 %
10.10	Barrick PD AU Finance Pty LT.....	2FE.....	\$.....2,928,523	.....0.448 %

11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure:

11.01 Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets?	Yes [X]	No []
If response to 11.01 is yes, detail is not required for the remainder of Interrogatory 11.		
11.02 Total admitted assets held in Canadian Investments	\$.....	.....0.000 %
11.03 Canadian currency-denominated investments	\$.....	.....0.000 %
11.04 Canadian-denominated insurance liabilities	\$.....	.....0.000 %
11.05 Unhedged Canadian currency exposure	\$.....	.....0.000 %

12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.

report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.		
12.01 Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets?		Yes [X] No []
If response to 12.01 is yes, responses are not required for the remainder of Interrogatory 12.		
	1	2 3
12.02 Aggregate statement value of investments with contractual sales restrictions:	\$.....	.....0.000 %
Largest three investments with contractual sales restrictions:		
12.03 .....	\$.....	.....0.000 %
12.04 .....	\$.....	.....0.000 %
12.05 .....	\$.....	.....0.000 %

13. Amounts and percentages of admitted assets held in the ten largest equity interests:

13.01 Are assets held in equity interest less than 2.5% of the reporting entity's total admitted assets?			Yes [] No [X]
If response to 13.01 above is yes, responses are not required for the remainder of Interrogatory 13.			
1	2	3	
<u>Name of Issuer</u>			
13.02 Exxon Mobil.....	\$.....913,927	.....0.140 %	
13.03 Apple Inc.....	\$.....699,955	.....0.107 %	
13.04 Microsoft.....	\$.....502,380	.....0.077 %	
13.05 IBM Corp.....	\$.....463,762	.....0.071 %	
13.06 General Electric.....	\$.....456,518	.....0.070 %	
13.07 Procter & Gamble.....	\$.....444,971	.....0.068 %	
13.08 Chevron.....	\$.....431,704	.....0.066 %	
13.09 AT&T.....	\$.....409,028	.....0.063 %	
13.10 Johnson & Johnson.....	\$.....403,262	.....0.062 %	
13.11 JP Morgan Chase.....	\$.....391,158	.....0.060 %	

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities:

14.01 Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets?			Yes [X]	No []
If response to 14.01 above is yes, responses are not required for the remainder of Interrogatory 14.				
	1	2	3	
14.02 Aggregate statement value of investments held in nonaffiliated, privately placed equities:		\$.....	.....0.000 %	
Largest three investments held in nonaffiliated, privately placed equities:				
14.03 .....		\$.....	.....0.000 %	
14.04 .....		\$.....	.....0.000 %	
14.05 .....		\$.....	.....0.000 %	

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests:

15.01 Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets?			Yes [X] No []
If response to 15.01 above is yes, responses are not required for the remainder of Interrogatory 15.			
1	2	3	
15.02 Aggregate statement value of investments held in general partnership interests:	\$.....	.....0.000 %	
Largest three investments in general partnership interests:			
15.03 .....	\$.....	.....0.000 %	
15.04 .....	\$.....	.....0.000 %	
15.05 .....	\$.....	.....0.000 %	

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans:

16.01 Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 16.01 above is yes, responses are not required for the remainder of Interrogatory 16 and Interrogatory 17.

	1	2	3
Type (Residential, Commercial, Agricultural)			
16.02 .....	\$.....	.....0.000 %	
16.03 .....	\$.....	.....0.000 %	
16.04 .....	\$.....	.....0.000 %	
16.05 .....	\$.....	.....0.000 %	
16.06 .....	\$.....	.....0.000 %	
16.07 .....	\$.....	.....0.000 %	
16.08 .....	\$.....	.....0.000 %	
16.09 .....	\$.....	.....0.000 %	
16.10 .....	\$.....	.....0.000 %	
16.11 .....	\$.....	.....0.000 %	

Amount and percentage of the reporting entity's total admitted assets held in the following categories of mortgage loans:

	Loans
16.12 Construction loans.....	\$.....0.000 %
16.13 Mortgage loans over 90 days past due.....	\$.....0.000 %
16.14 Mortgage loans in the process of foreclosure.....	\$.....0.000 %
16.15 Mortgage loans foreclosed.....	\$.....0.000 %
16.16 Restructured mortgage loans.....	\$.....0.000 %

17. Aggregate mortgage loans having the following loan-to-value ratios as determined from the most current appraisal as of the annual statement date:

Loan-to-Value	1	Residential	2	Commercial	3	4	Agricultural	5	6
17.01 above 95%.....	\$.....	.....0.000 %	\$.....	.....0.000 %	\$.....	.....0.000 %	.....0.000 %	\$.....	.....0.000 %
17.02 91% to 95%.....	\$.....	.....0.000 %	\$.....	.....0.000 %	\$.....	.....0.000 %	.....0.000 %	\$.....	.....0.000 %
17.03 81% to 90%.....	\$.....	.....0.000 %	\$.....	.....0.000 %	\$.....	.....0.000 %	.....0.000 %	\$.....	.....0.000 %
17.04 71% to 80%.....	\$.....	.....0.000 %	\$.....	.....0.000 %	\$.....	.....0.000 %	.....0.000 %	\$.....	.....0.000 %
17.05 below 70%.....	\$.....	.....0.000 %	\$.....	.....0.000 %	\$.....	.....0.000 %	.....0.000 %	\$.....	.....0.000 %

18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate:

18.01 Are assets held in real estate reported less than 2.5% of the reporting entity's total admitted assets?

Yes [X] No []

If response to 18.01 above is yes, responses are not required for the remainder of Interrogatory 18.

Largest five investments in any one parcel or group of contiguous parcels of real estate.

Description	2	3
18.02 .....	\$.....	.....0.000 %
18.03 .....	\$.....	.....0.000 %
18.04 .....	\$.....	.....0.000 %
18.05 .....	\$.....	.....0.000 %
18.06 .....	\$.....	.....0.000 %

19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments held in mezzanine real estate loans.

19.01 Are assets held in investments held in mezzanine real estate loans less than 2.5% of the reporting entity's admitted assets?

Yes [X] No []

If response to 19.01 is yes, responses are not required for the remainder of Interrogatory 19.

	1	2	3
19.02 Aggregate statement value of investments held in mezzanine real estate loans:	\$.....	.....0.000 %	
Largest three investments held in mezzanine real estate loans.			
19.03 .....	\$.....	.....0.000 %	
19.04 .....	\$.....	.....0.000 %	
19.05 .....	\$.....	.....0.000 %	

20. Amounts and percentages of the reporting entity's total admitted assets subject to the following types of agreements:

	At Year-End	1st Qtr	At End of Each Quarter	2nd Qtr	3rd Qtr
	1	2	3	4	5
20.01 Securities lending agreements (do not include assets held as collateral for such transactions).....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
20.02 Repurchase agreements.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
20.03 Reverse repurchase agreements.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
20.04 Dollar repurchase agreements.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
20.05 Dollar reverse repurchase agreements.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....

21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps and floors:

	<u>Owned</u>		<u>Written</u>	
	1	2	3	4
21.01 Hedging.....	\$.....	.....0.000 %	\$.....	.....0.000 %
21.02 Income generation.....	\$.....	.....0.000 %	\$.....	.....0.000 %
21.03 Other.....	\$.....	.....0.000 %	\$.....	.....0.000 %

22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:

	At Year-End	1st Qtr	At End of Each Quarter	2nd Qtr	3rd Qtr
	1	2	3	4	5
22.01 Hedging.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
22.02 Income generation.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
22.03 Replications.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
22.04 Other.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....

23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:

	<u>At Year-End</u>		1st Qtr	<u>At End of Each Quarter</u>	
	1	2	3	2nd Qtr	3rd Qtr
				4	5
23.01 Hedging.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
23.02 Income generation.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
23.03 Replications.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....
23.04 Other.....	\$.....	.....0.000 %	\$.....	\$.....	\$.....



December 22, 2015

Bill Thielen, Executive Director
Kentucky Retirement Systems
Perimeter Park West
1260 Louisville Road
Frankfort, KY 40601-6124

Mr. Thielen,

The Council of State Governments ("CSG") desires to voluntarily cease participation in the Kentucky Employees Retirement System ("KERS") pursuant to KRS 61.522 and 105 KAR 1:145. Accordingly, CSG has attached the following documents:

1. Attachment 1, Completed Form 7725, "Request for Estimated Actuarial Cost of Voluntary Cessation".
2. Attachment 2, Check in the amount of Five Thousand Dollars and Zero Cents (\$5000.00) made payable to Kentucky Retirement Systems for calculation of the estimated actuarial cost of voluntary cessation.
3. Attachment 3, Completed Form 7730, "Application for Voluntary Cessation from CERS and KERS".
4. Attachment 4, Check in the amount of Ten Thousand Dollars and Zero Cents (\$10,000.00) made payable to Kentucky Retirement Systems as a deposit for administrative costs incurred in processing CSG's application.
5. Attachment 5, List of current CSG Executive Committee Members.
6. Attachment 6, CSG's resolution requesting to cease participation in KERS.
7. Attachment 7, Notarized copy of the minutes from CSG's Executive Committee meeting of December 13, 2015, in which the resolution was adopted. These minutes will not be approved by CSG's Executive Committee until the next meeting of the Executive Committee in December, 2016.
8. Attachment 8, Copy of CSG's Articles of Organization.
9. Attachment 9, List of full names, last known addresses, dates of birth, social security numbers, beginning and ending dates of employment, and sick leave balances of all

The Council of State Governments National Headquarters

3000 Research Park Drive • Lexington, KY 40511-8483 • (502) 244-8000 • Fax (502) 244-8000 • www.csg.org

Eastern Office
New York
(212) 482-2320
www.csgny.org

Midwestern Office
Lombard, IL
(630) 925-1922
www.csgmidwest.org

Southern Office
Atlanta
(404) 633-1666
www.csgflorida.org

Western Office
Sacramento, CA
(916) 553-9423
www.csgwest.org

Washington Office
Washington, DC
(202) 334-9450
www.csgdc.org

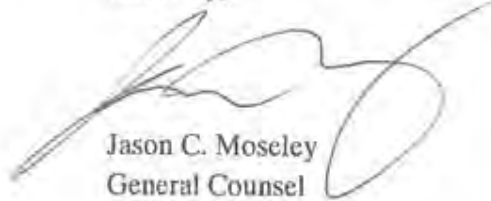
current and former full time CSG employees. This information was transmitted to Brian Thomas via secure electronic mail on December 21, 2015.

10. Attachment 10, CSG's most recent five (5) audited financial statements and independent auditor reports.
11. Attachment 11, Documentation of the alternative retirement program created by CSG for its employees.
12. Attachment 12, Documentation of the source of funds CSG intends to use to pay the full actuarial cost.

Regarding active lawsuits, legal actions, arbitrations, mediations and other litigation, CSG is not currently the subject of any such actions. As a result, there is no information to produce.

Please contact me at the number below if there is any additional information needed or if there are any questions.

Sincerely,



Jason C. Moseley
General Counsel
859-244-8145

Attachment 1

Completed Form 7725

“Request for Estimated Actuarial Cost of Voluntary Cessation”

**Kentucky Retirement Systems**

Perimeter Park West • 1260 Louisville Rd. • Frankfort KY 40601-6124
Phone: (502) 696-8800 • Fax: (502) 696-8822 • kyret.ky.gov



Form 7725
Revised 10/2015

Request For Estimated Actuarial Cost of Voluntary Cessation**Agency Information**

Full Legal Name of Agency: The Council of State Governments		Phone Number: 859-244-8000	
Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511
KRS Employer Code 1492			

Name of person to contact regarding this application for estimate: Jason Moseley, The Council of State Governments			
Address: 2760 Research Park Drive		City: Lexington	State: KY
		Zip Code: 40511	
Phone Number: 859-244-8145	Fax: 859-244-8001	E-mail: jmoseley@csg.org	

Name of Agency Head: David Adkins, Executive Director/CEO, The Council of State Governments			
Address: 2760 Research Park Drive		City: Lexington	State: KY
		Zip Code: 40511	
Phone Number: 859-244-8000	Fax: 859-244-8001	E-mail: dadkins@csg.org	

Name of Reporting Official: Jason Moseley, General Counsel, The Council of State Governments			
Address: 2760 Research Park Drive		City: Lexington	State: KY
		Zip Code: 40511	
Phone Number: 859-244-8145	Fax: 859-244-8001	E-mail: jmoseley@csg.org	

Name of Attorney representing agency (if any): Jason Moseley, General Counsel, The Council of State Governments			
Address: 2760 Research Park Drive		City: Lexington	State: KY
		Zip Code: 40511	
Phone Number: 859-244-8145	Fax: 859-244-8001	E-mail: jmoseley@csg.org	

This estimate of the full actuarial cost of voluntary cessation provided by Kentucky Retirement Systems will be based on unaudited information currently in Kentucky Retirement Systems' database with projections that current employees will stay employed and earn service credit until the next available cessation date and will continue to earn the same creditable compensation. Pursuant to 105 KAR 1:145, this estimate shall not be binding on Kentucky Retirement Systems and shall not be relied upon by the requesting employer.

I, David Adkins Executive Director/CEO acknowledge and agree
Name of Agency Head Title of Agency Head

that the estimate of the full actuarial cost of voluntary cessation to be provided by Kentucky Retirement Systems is only an estimate based on unaudited information currently in Kentucky Retirement Systems' database with projections that current employees will stay employed and earn service credit until the next available cessation date and will continue to earn the same creditable compensation. Pursuant to 105 KAR 1:145, this estimate shall not be binding on Kentucky Retirement Systems and shall not be relied upon by the requesting employer.

David Adkins, CEO
Agency Head Signature

Attachment 2

Check in the amount of \$5,000.00 for administrative costs of calculating estimated actuarial cost, as per Form 7725.

17572

THE COUNCIL OF STATE GOVERNMENTS

P.O. BOX 11910
LEXINGTON, KY 40578-1910

73-151-421

PAY
TO THE
ORDER OF

Kentucky Retirement System
Five thousand and no/100

Sept 2015

DATE

\$

5000.00

DOLLARS



Security Features
Check on Back



Traditional Bank

LEXINGTON, KENTUCKY 40507

[Signature]

FOR

Form 775

⑈0⑆7572⑈ ⑈042⑆05⑆⑈ 00⑆035⑆3⑈

MP

Attachment 3

Completed Form 7730

“Application for Voluntary Cessation from CERS and KERS”

**Kentucky Retirement Systems**

Perimeter Park West • 1260 Louisville Rd. • Frankfort KY 40601-6124
Phone: (502) 696-8800 • Fax: (502) 696-8822 • kyret.ky.gov



Form 7730
Revised 11/2015

Application for Voluntary Cessation From CERS or KERS**Agency Information**

Full Legal Name of Agency: The Council of State Governments		Phone Number: 859-244-8000	
Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511

KRS Employer Code 1492

Name of person to contact regarding this application: Jason Moseley, General Counsel, The Council of State Governments

Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511
Phone Number: 859-244-8145	Fax: 859-244-8001	E-mail: jmoseley@csg.org	

Name of Agency Head: David J. Adkins, Executive Director/CEO, The Council of State Governments

Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511
Phone Number: 859-244-8000	Fax: 859-244-8001	E-mail: dadkins@csg.org	

Name of Reporting Official: Jason Moseley, General Counsel, The Council of State Governments

Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511
Phone Number: 859-244-8145	Fax: 859-244-8001	E-mail: jmoseley@csg.org	

Name of Attorney representing agency: Jason Moseley, General Counsel, The Council of State Governments

Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511
Phone Number: 849-244-8145	Fax: 859-244-8001	E-mail: jmoseley@csg.org	

Board Chair: State Senator Carl Marcellino, New York

Attach List of Current Board Members

Date of Resolution: (Attach Resolution) December 13, 2015

Attach Notarized copy of the official minutes of the meeting the resolution was adopted, if applicable

Name of proposed Alternative Retirement Program: TIAA-CREF defined contribution plans

Type of Plan: 401(a) employer contribution and 403(b) employee contribution plans

*Attach documentation of alternative retirement plan***If the agency is a corporation organized under KRS Chapter 273:**Secretary of State Organization Number:

Name of Registered Agent: David J. Adkins, Executive Director/CEO, The Council of State Governments

Address: 2760 Research Park Drive	City: Lexington	State: KY	Zip Code: 40511
-----------------------------------	-----------------	-----------	-----------------

Attach copies of Articles of Incorporation, By-Laws, Certificate of Existence/Authorization, if applicable

Attach the following information for all current and former full time employees:

- Full names;
 - Last known addresses;
 - Dates of Birth;
 - Social Security Numbers of Kentucky Retirement Systems Member IDs;
 - Beginning dates of employment, if applicable;
 - Ending dates of employment, if applicable; and
 - Sick leave balances;
 - Provide a list of active lawsuits, legal actions, arbitrations, mediations and other litigation, except for cases in which the employer is seeking to collect a debt owed to it by one of its members, pending to which the employer is a party including:
 - Name of the case;
 - Number of the case;
 - The name and address of the Court, arbitrator, mediator, or administrative agency in which the case is pending.
- Attach a copy of the Complaint or a description of the allegations made in the Complaint as well as the type and amount of relief being sought.*

Attach:

- The employer's most recent five (5) audited financial statements and independent auditor's reports;
- The employer's most recent five (5) Consolidated Annual Financial Reports, if applicable;

☒ If employer intends to pay by lump sum:

- Documentation of the employer's plan to pay the full actuarial cost including:
- Funding source;

☐ If employer intends to pay by installment payment plan:

- Documentation of the employer's plan to pay the full actuarial cost including:
- Funding source;
- List of real property owned by the employer, including deeds of conveyance, title, all liens or encumbrances on the real property and any current written contractual lease or rental agreement of the real property identified;
- List of liabilities of the employer; and inventory of all other chattel and personal property owned by the employer or in which the employer has an interest that may be used as collateral by the employer, including a description of the property, the location of the property, and an estimated value;
- Proposed Detailed Financing Statement, if the employer intends to pay in installments;

Name of Attorney preparing Detailed Financing Statement: _____

Address: _____

City: _____

State: _____

Zip Code: _____

Phone Number: _____

Fax: _____

E-mail: _____

I, David Atkins, Executive Director / CEO acknowledge
NAME OF AGENCY HEAD TITLE OF AGENCY HEAD

and agree that The Council of State Governments is subject to and will comply with all the provisions KRS 61.552 and
NAME OF AGENCY

KAR 1:145.

David Atkins, CEO
Signature line for Agency Head

I, Sen. Carl Marcellino, Chair of the Board of Trustees, acknowledge and agree that
NAME OF BOARD CHAIR

The Council of State Governments is subject to and will comply with all the provisions KRS 61.552 and 105 KAR 1:145.
NAME OF AGENCY

Sen. Carl Marcellino
Signature line for Board Chair

Attachment 4

Check in the amount of \$10,000.00 for administrative costs, as per Form 7730.

17573

THE COUNCIL OF STATE GOVERNMENTS

P.O. BOX 11910
LEXINGTON, KY 40578-1910

73-151-421

DATE

12/22/15

PAY
TO THE
ORDER OF

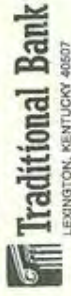
Kentucky Retirement System

\$

10,000.00

DOLLARS

10



Traditional Bank

LEXINGTON, KENTUCKY 40507

[Signature]

FOR

Form 7730

⑆017573⑆ ⑆042101514⑆ 00103543⑆

MP

Attachment 5

List of current CSG Executive Committee Members



The Council of State Governments
Shaping Capitol Ideas

**THE COUNCIL OF STATE GOVERNMENTS
EXECUTIVE COMMITTEE
ROSTER AS OF 12/1/2015**

ALABAMA

Mr. Jerry L. Bassett

Director

Legislative Reference Service

613 Alabama State House
Montgomery, AL 36130

Phone: (334) 242-7577

Fax: (334) 242-4358

Email: jelbalrs@aol.com

ALASKA

Representative Craig Johnson

State Capitol Building
Room 216

Anchorage, AK 99801

Phone: (907) 269-0200

Fax: (907) 269-0204

Email: representative.craig.johnson@akleg.gov

Senator Gary Stevens

CSG Chair 2013

305 Center Avenue, Suite 1
Kodiak, AK 99615

Phone: (907) 486-4925

Fax: (907) 486-5264

Email: Senator.Gary.Stevens@akleg.gov

ARKANSAS

Senator Linda Chesterfield

12 Keo Drive

Little Rock, AR 72206

Phone: (501) 888-1859

Email: lchesterfield@comcast.net

Senator Keith M. Ingram

Senate Minority Leader

P.O. Box 1028

West Memphis, AR 72303

Phone: (870) 735-9580

Fax: (870) 735-5799

Email: friendsforkeith@gmail.com

COLORADO

Senator Nancy Todd

11293 E. Harvard Drive

Aurora, CO 80014-1710

Phone: (916) 553-3432

Email: senatornancytodd@gmail.com

CONNECTICUT

Representative Bob Godfrey

House Deputy Speaker

CSG Chair 2011

13 Stillman Avenue

Danbury, CT 06810

Phone: (203) 778-5127

Email: Bob.Godfrey@cga.ct.gov

DELAWARE

Representative Deborah Hudson

House Minority Whip

CSG Chair 2007

1022 Oriente Avenue
Wilmington, DE 19801

Phone: (302) 577-8723

Fax: (302) 577-6396

Email: Deborah.Hudson@state.de.us

Representative Helene M. Keeley

House Speaker Pro Tem

P.O. Box 2716
Wilmington, DE 19805

Phone: (302) 577-8476

Email: helene.keeley@state.de.us

Senator David P. Sokola

Carvel State Office Building, 11th Floor
820 North French Street

Wilmington, DE 19801

Phone: (302) 577-8744

Email: senatordave@live.com

FLORIDA

Mr. Bryan Koon

Director

Florida Division of Emergency Management

2555 Shumard Oak Blvd.
Tallahassee, FL 32399

Phone: (850) 413-9969

Email: bryan.koon@em.myflorida.com

GEORGIA

Representative David Ralston

House Speaker

P.O. Box 188
Blue Ridge, GA 30513

Phone: (706) 632-2221

Fax: (706) 632-6193

Email: david.ralston@house.ga.gov

HAWAII

Ms. Charlotte A. Carter-Yamauchi

Acting Director

Legislative Reference Bureau

State Capitol, Room 446
415 South Beretania Street
Honolulu, HI 96813

Phone: (808) 587-0666

Fax: (808) 587-0681

Email: yamauchi@capitol.hawaii.gov

IDAHO

Representative Maxine T. Bell

194 South 300 East
Jerome, ID 83338

Phone: (208) 324-4296

Email: mhjbel@live.com

Senator Bart M. Davis

Senate Majority Leader

CSG Chair 2009

2638 Bellin Circle
Idaho Falls, ID 83402

Phone: (208) 522-8100

Fax: (208) 522-1334

Email: bartdavis@ms.com

Representative Jeff Thompson

1739 Peggy's Lane
Idaho Falls, ID 83402

Phone: (208) 681-4310

Email: jeffdtomp@aol.com

INDIANA

Representative Ed Clere

1701 Depauw Avenue
New Albany, IN 47150-2745

Phone: (812) 949-5078

Email: edclere@gmail.com

Ms. Lilia G. Judson

Interim Chief Administrative Officer

Indiana Supreme Court

30 South Meridian Street

Suite 500

Indianapolis, IN 46204

Phone: (317) 232-2542

Fax: (317) 233-6586

Email: lilia.judson@courts.in.gov

Senator David C. Long

President Pro Tempore

7100 W. Jefferson Blvd.

Fort Wayne, IN 46804

KANSAS**Mr. Jay Scott Emler**

Commissioner

Kansas Corporation Commission

CSG Chair 2012

1500 Southwest Arrowhead Road

Topeka, KS 66604

Phone: (785) 271-3166

Email: j.emler@kcc.ks.gov

Senator Vicki Schmidt

5906 Southwest 43rd Court

Topeka, KS 66610

Phone: (785) 267-4686

Email: vicki.schmidt@mac.com

KENTUCKY**Ms. Rebecca Harilson**

Chief of Staff

Office of the Senate President

Room 236, Capitol Annex Building

Frankfort, KY 40601

Phone: (502) 564-3120

Fax: (502) 564-0456

Email: becky.harilson@lrc.ky.gov

Senator Robert Stivers

Senate President

207 Main Street

Manchester, KY 40962

Phone: (606) 598-8575

Email: robert.stivers@lrc.ky.gov

Representative Gregory D. Stumbo

House Speaker

108 Cassidy Drive

P.O. Box 1473

Prestonsburg, KY 41653

Phone: (606) 886-9953

Email: Greg.Stumbo@lrc.ky.gov

The Honorable David L. Williams

Circuit Judge

CSG Chair 2010

P.O. Box 666

Burkesville, KY 42717

Phone: (270) 433-1234

Email: sendavidwilliams@icloud.com

MINNESOTA**Representative Patrick Garofalo**

5997 193rd Street, West

Farmington, MN 55024

Phone: 651.338.4166

Email: rep.pat.garofalo@gmail.com

MISSISSIPPI**Senator Will Longwitz**

P.O. Box 1273

Madison, MS 39130

Phone: (601) 605-5879

Email: will@willongwitz.com

Representative Bobby Moak

P.O. Box 242

Bogue Chitto, MS 39629

Phone: (800) 595-6244

Email: bobbymoak402@att.net

MISSOURI

The Honorable Jay Nixon

Governor

CSG President 2013

P.O. Box 720
Jefferson City, MO 65102

Phone: (573) 751-4917
Fax: (573) 751-1906
Email: Judy.Murray@mo.gov

NEBRASKA

Senator Beau McCoy

3922 South 190th Street
Omaha, NE 68130

Phone: (402) 471-2885
Email: bmccoy@leg.ne.gov

NEVADA

Senator Kelvin D. Atkinson

Senate Minority Co-Whip

4165 Fuselier Drive
Las Vegas, NV 89032

Phone: (702) 457-9995
Fax: (702) 457-9995
Email: kelvin@atkinson4nevada.com

The Honorable Nancy Saitta

201 South Carson Street
Carson City, NV 89701

Phone: (775) 684-1530
Fax: (775) 684-1533
Email: nsaitta@nvcourts.nv.gov

The Honorable Brian Sandoval

Governor

CSG President 2015

State Capitol
101 North Carson Street
Carson City, NV 89701
Phone: (775) 684-5670
Fax: (775) 684-5670

NEW HAMPSHIRE

The Honorable Joseph Foster

Attorney General

State House Annex
33 Capitol Street
Concord, NH 03301
Phone: (603) 271-1202
Fax: (603) 271-2110
Email: pam.murphy@doj.nh.gov

NEW YORK

Senator Hugh T. Farley

Senate Vice President Pro Tempore

CSG Chair 1987

711 LOB
Albany, NY 12248

Phone: (518) 885-1829
Fax: (518) 885-1970
Email: farley@nysenate.gov

Senator Carl L. Marcellino

Senate Majority Conference Vice Chairman

CSG Chair 2015

250 Townsend Square
Oyster Bay, NY 11771
Phone: (516) 922-1811
Email: marcellino@nysenate.gov

NORTH DAKOTA

Senator Tim Flakoll

1350 Second Street, North
Fargo, ND 58102

Phone: (701) 367-5954
Email: tflakoll@nd.gov

Representative Kim Koppelman

CSG Chair 2008

513 First Avenue, Northwest
West Fargo, ND 58078
Phone: (701) 282-9267
Email: Koppelman@KoppAssoc.com

The Honorable Wayne Stenehjem

Attorney General

600 East Boulevard Avenue #125
Bismarck, ND 58505

Phone: (701) 328-2213

Fax: (701) 328-2226

Email: ndag@nd.gov

OKLAHOMA**Mr. Michael C. Thompson**

Commissioner

Department of Public Safety

3600 N. Martin Luther King Avenue
Oklahoma City, OK 73111

Phone: (405) 425-2001

Email: mike.thompson@dps.state.ok.us

OREGON**Representative Brad Witt**

900 Court Street, Northeast
H-374

Salem, OR 97301

Phone: (503) 986-1431

Email: rep.bradwitt@state.or.us

PENNSYLVANIA**The Honorable Pedro A. Cortes**

Secretary of the Commonwealth

Office of the Secretary

302 North Office Building
Harrisburg, PA 17120

Phone: (717) 787-6458

Fax: (717) 787-1734

Email: mpeiffer@pa.gov

QUEBEC**Mr. Guy Ouellette**

Member of the National Assembly

National Assembly of Québec

1050 Rue Des Parlementaires

4E Etage

Quebec, QC G1A 1A3

CANADA

Email: gouellette@assnat.qc.ca

SOUTH DAKOTA**Representative Jacqueline Sly**

22560 Potter Road

Rapid City, SD 57702

Phone: (605) 343-4956

Email: rep.sly@state.sd.us

Senator Mike Vehle

132 North Harmon Drive
Mitchell, SD 57301

Phone: (605) 996-5778

Email: sen.vehle@sd.us.com

TENNESSEE**Representative John J. DeBerry Jr.**

1207 Sledge Street
Memphis, TN 38104

Phone: (901) 725-0130

Email: rep.john.deberry@capitol.tn.gov

The Honorable Tre Hargett

Secretary of State

State Capitol, First Floor
Nashville, TN 37243

Phone: (615) 741-2819

Email: tawnie.mathieu@tn.gov

Senator Mark Norris

Senate Majority Leader

CSG Chair 2014

Suite 9A, Legislative Plaza

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Nashville, TN 37243

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The Honorable Earl Ray Tomblin

Governor

CSG Chair 2006

CSG President 2014

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Attachment 6

CSG's resolution requesting to cease participation in KERS.



RESOLUTION TO VOLUNTARILY CEASE CSG'S PARTICIPATION IN THE KENTUCKY EMPLOYEES RETIREMENT SYSTEM

WHEREAS, The Council of State Governments ("CSG") relocated its headquarters office to Lexington, Kentucky in 1969; and

WHEREAS, beginning in 2003, through an executive order by Gov. Paul Patton, current CSG Headquarters employees based in Kentucky were given the option to participate in the Kentucky Employees Retirement System and all future CSG Headquarters employees based in Kentucky were required to participate in the Kentucky Employees Retirement System; and

WHEREAS, since entering the system, the employer contribution rate to participate in the Kentucky Employees Retirement System has increased from 5.89% to 38.77%, which, for fiscal year 2014, resulted in a cost of more than \$1.3 million for CSG; and

WHEREAS, during the 2015 legislative session the Kentucky General Assembly passed and Gov. Steve Beshear signed into law House Bill 62 which created a mechanism for participating organizations to pay the full actuarial cost of withdrawal and all administrative costs for their organization and voluntarily cease participation in the Kentucky Retirement System; and

WHEREAS, the Kentucky Retirement System requires a resolution formally adopted by each organization seeking to voluntarily cease participation in the system through which the organization states its intention and acknowledges the authority of the Kentucky Retirement System and process created by statute and regulation.

NOW, THEREFORE BE IT RESOLVED, The Council of State Governments has decided to voluntarily cease participation in the Kentucky Employees Retirement System; and

BE IT FURTHER RESOLVED, CSG acknowledges that it is subject to the requirements and restrictions of KRS 61.522 and 105 KAR 1:145; and

BE IT FURTHER RESOLVED, CSG acknowledges that in order to voluntarily cease participation in the Kentucky Employees Retirements System, it shall pay the full actuarial cost of withdrawal and all administrative costs; and

BE IT FURTHER RESOLVED, CSG acknowledges that its employees will no longer earn service credit in the Kentucky Employees Retirement System for employment with CSG after CSG's approved cessation date from the Kentucky Employees Retirement System under KRS 61.522 and 105 KAR 1:145; and

BE IT FURTHER RESOLVED, CSG agrees to cooperate with the Kentucky Retirement System to educate its employees about the effect of CSG's cessation on their retirement accounts and their options regarding their retirement accounts; and

BE IT FURTHER RESOLVED, CSG shall not mandate, force, or require, its employees to take a refund of their accumulated account balance as defined in KRS 61.510(41) or 78.510(38) or retaliate against its employees who do not chose to take refunds of their accumulated account balance as defined in KRS 61.510(41) or 78.510(38).

Adopted this 13th Day of December 2015 by The Council of State Governments' Executive Committee.

A handwritten signature in cursive script, appearing to read 'Carl Marcellino', written over a horizontal line.

State Senator Carl Marcellino, New York
2015 CSG National Chair

Attachment 7

Notarized copy of minutes from CSG Executive Committee meeting of December 13, 2015 in which resolution was adopted.



THE COUNCIL OF STATE GOVERNMENTS EXECUTIVE COMMITTEE

Meeting Summary
CSG National Conference – December 13, 2015
Nashville, Tennessee

Presiding: Senator Carl Marcellino – CSG Chair

Members in Attendance:

Sen. Kelvin Atkinson, Nevada
Mr. Jerry Bassett, Director, Legislative Reference Service, Alabama
Ms. Charlotte Carter-Yamauchi, Acting Director, Legislative Reference Bureau, Hawaii
Sen. Bart Davis, Idaho
Sen. Hugh Farley New York
Sen. Tim Flakoll, North Dakota
Dep. Speaker Bob Godfrey, Connecticut
Ms. Rebecca Harlison, Chief of Staff to Senate President Robert Stivers, Kentucky
Rep. Deborah Hudson, Delaware
Rep. Sam Hunt, Washington
Rep. Craig Johnson, Alaska
Ms. Lilia Judson, State Court Administrator Indiana
Mr. Bill Koon, Director of Emergency Management, Florida
Rep. Kim Koppelman, North Dakota
Sen. Will Longwitz, Mississippi
Sen. Carl Marcellino, New York
Sen. Beau McCoy, Nebraska
Rep. Bobby Moak, Mississippi
Sen. Mark Norris, Tennessee
MNA Guy Ouellette, Quebec
Rep. Larry Phillips, Texas
Justice Nancy Saitta, Nevada
Sen. Vicki Schmidt, Kansas
Rep. Jacqueline Sly, South Dakota
Sen. Gary Stevens, Alaska
Senate President Robert Stivers, Kentucky
Rep. Jeff Thompson, Idaho
Sen. Mike Vehle, South Dakota
Judge David Williams, Kentucky

Staff in attendance:

Mr. David Adkins, CSG
Ms. Kelley Arnold, CSG
Mr. Chip Barton, CSG
Ms. Wendell Hannaford, CSG East
Mr. Andy Karellas, CSG
Mr. Wade Littrell, CSG
Mr. Mike McCabe, CSG Midwest
Ms. Maggie Mick, CSG
Mr. Jason Moseley, CSG
Mr. John Mountjoy, CSG
Mr. Michael Robinson, CSG

Mr. Edgar Ruiz, CSG West
Ms. Kathleen Turner, CSG

I. CALL TO ORDER, WELCOME AND INTRODUCTIONS

The meeting of CSG's Executive Committee was called to order by Chair Marcellino at 11:07 a.m. Chair Marcellino welcomed the committee and thanked the host state and sponsors for their support of the 2015 CSG National Conference in Nashville, Tennessee.

II. APPROVAL OF CSG EXECUTIVE COMMITTEE MEETING SUMMARY, AUGUST 2014

Following a review of the agenda, introductions of committee members and guests, and the recognition of a quorum, Chair Marcellino called for approval of the meeting summary from the CSG Executive Committee meeting in Anchorage, Alaska from August 13, 2014. A motion to accept the meeting summary was made, seconded, and unanimously approved (attached as Exhibit A).

III. CSG EXECUTIVE DIRECTOR'S REPORT

Chair Marcellino called on CSG Executive Director/CEO David Adkins to provide the executive director's report. Mr. Adkins welcomed the committee and praised the efforts of CSG headquarters staff, regional staff, host state volunteers and sponsors for their hard work and efforts in coordinating the success of the CSG 2015 National Conference and related events. In addition, Mr. Adkins thanked the members, staff, sponsors and guests for their participation in the morning's food packaging event, which lasted approximately 2 hours and prepared 31,000 meals for donation to the Second Harvest Food Bank of Middle Tennessee.

Mr. Adkins reported on the following:

- The completed renovation project of CSG headquarters facility in Lexington and successful Open House/Ribbon Cutting ceremony held on August 31. Over 125 CSG members, Toll Fellows, regional staff and guests attended.
- Renovations to CSG's Washington, DC office will begin January 1, 2016 and should take approximately 6 to 8 weeks.
- A special internal task force has been created to assess the renovation and maintenance needs of the Sprague Building on CSG's campus in Lexington, Kentucky. The task force is comprised of CSG affiliate organization representatives and CSG staff.
- The CSG Justice Center continues to grow and recently moved to a new office in New York City.
- Chair Marcellino has continued to advance CSG's State Pathways to Prosperity initiative. His appointment as the Chair of the Senate Education

Committee in New York has contributed to the success of CSG's National Task Force on Workforce Development and Education. As a result of the task forces' efforts, a report entitled "A Framework for State Policymakers: Developing Pathways to Ensure a Skilled Workforce for State Prosperity" was prepared. This report contains the work product of the task force and four subcommittees, representing more than a year of study, dialogue and deliberation by state officials from both parties, all regions of the U.S. and from diverse perspectives. A copy of the report was provided to the committee.

- CSG's Policy and Research Team has had a successful year. A copy of a brochure outlining the year's accomplishments was provided to the committee. This included information on numerous policy academies, publications, online tools and compacts from 2015.

Mr. Adkins advised the committee that this meeting would focus on *action* items only. Written reports from CSG's regions, the CSG Justice Center, CSG's DC Office, affiliated organizations and various other CSG committees were included in the meeting materials for review (attached as Exhibit B).

Mr. Adkins thanked the committee and Chair Marcellino for their continued support of CSG in what has been an excellent year of service to the states.

IV. CSG LEADERSHIP COUNCIL REPORT

Chair Marcellino called on Rep. Bobby Moak to provide an update on modifications to CSG's Suggested State Legislation Program. Rep. Moak referenced a memorandum from him to the CSG Executive Committee (attached as Exhibit C) advising the committee that a subcommittee met in June to review SSL committee practices.

The subcommittee made recommendations regarding changes to parliamentary procedures used by the SSL committee, criteria for submission of bills for consideration by the SSL committee, revisions to the SSL committee's categories and also docket item disposition. These revisions were discussed and approved by the full SSL Committee during its meeting in June. In addition, the subcommittee offered several housekeeping observations and suggestions, with regard to the SSL process.

The SSL Subcommittee discussed the need for an overall committee name change to more accurately reflect the purpose of the committee. As stated in CSG's Articles of Organization, the SSL Committee's work does not represent an endorsement of state legislation and CSG will not advocate for the adoption of legislation. The subcommittee recommended the name be changed to "CSG's Emerging State Legislation Committee."

Following a lengthy discussion of various committee names, Rep. Godfrey moved that the present name "CSG's Suggested State Legislation" be changed

to "CSG's Shared State Legislation Program." The motion was seconded. A vote was taken and the motion was unanimously approved.

Mr. Adkins reported that approval by the CSG Executive Committee was needed on a request submitted by the Association of Air Pollution Control Agencies (AAPCA) to pursue affiliation with The Council of State Governments (attached as Exhibit D). Rep. Godfrey moved that the affiliation request from AAPCA be approved pending the successful negotiation of a memorandum of understanding between CSG and AAPCA. The motion was unanimously approved.

V. CSG FINANCE COMMITTEE REPORT

Mr. Adkins reported that Rep. Bell, co-chair of the Finance Committee, was not able to attend the meeting today. He commended the efforts of CSG staff including Wade Littrell, chief financial officer and Jason Moseley, legal counsel, on their monthly communication efforts with the co-chairs on the status of the budget and update on financial matters involving CSG.

Chair Marcellino called on Sen. Schmidt, co-chair of the CSG Finance Committee, to provide an update on the FY 2015 CSG HQ/DC budget (attached as Exhibit E).

Sen. Schmidt also reported on the 2016 HQ/DC proposed budget (attached as Exhibit F). Sen. Schmidt made a motion that the 2016 HQ/DC proposed budget be approved; the motion was unanimously approved.

Sen. Schmidt reported on the CSG Budget for FY 2017 and the increase in dues for FY 2017 and FY 2018 (attached as Exhibit G). As per the unanimous decision of the CSG Finance Committee, dues were authorized to increase by 4% for each of the next two dues cycles (2017 and 2018) and then re-evaluated. A motion to accept the CSG Finance Committee recommendation was made by Sen. Flakoll and was unanimously approved.

Sen. Schmidt reported on the current status of the most recent legislative and regulatory activity involving CSG and the Kentucky Retirement System. Sen. Schmidt noted that a resolution passed by the CSG Executive Committee was necessary in order to comply with Kentucky's regulatory notification deadline of December 31, 2015 for those organizations seeking to exit the Kentucky Employees Retirement System (KERS) in 2016. Sen. Schmidt noted that this was the first step in the process and made a motion to accept the CSG Finance Committee resolution authorizing CSG's voluntary cessation of participation in KERS. The motion was seconded. Chair Marcellino called for discussion.

Senate President Stivers recused himself from the discussion and vote due to a conflict of interest. Judge Williams questioned the committee on who would have the authority to make decisions during the interim period between CSG Executive Committee meetings to ensure that CSG could move quickly to execute any necessary agreements or documents with Kentucky Retirement Systems should it become necessary. Judge Williams stated he did not want CSG to lose the

opportunity to withdraw from the system should it require immediate attention. Judge Williams proposed a temporary delegation of authority to CSG's Leadership Council for the purpose of taking any action necessary between meetings of the CSG Executive Committee to pursue voluntary cessation of participation in the Kentucky Retirement System. Sen. Schmidt amended her previous motion to include such temporary delegation of authority to CSG's Leadership Council until the next scheduled meeting of the CSG Executive Committee in December 2016. The amended motion was seconded and Chair Marcellino called for discussion.

Sen. Davis asked if the CSG Executive Committee already maintained the power to delegate this authority to the CSG Leadership Council. Mr. Moseley confirmed that under Article IV, Sect. 7(L) of CSG's Articles of Organization this was permitted.

The resolution and temporary delegation were unanimously approved (attached as Exhibit H).

Sen. Schmidt reported to the committee that during the 2015 Kentucky legislative session, the Kentucky General Assembly passed and signed into law HB 440 allowing unincorporated nonprofit associations to register with the Kentucky Secretary of State's office, file a certificate of association and receive limited liability status. CSG would add to its name, "Limited" or "Ltd" in legal contracts only and such a name change would not impact CSG's branding, visual identity or require the use of the term(s) in normal business. Sen. Schmidt made a motion to accept the CSG Finance Committee resolution authorizing the change in legal status and the resolution was unanimously approved (attached as Exhibit I).

VI. CSG INTERGOVERNMENTAL AFFAIRS COMMITTEE REPORT

Chair Marcellino called on Rep. Godfrey to report on six proposed policy resolutions that had been forwarded to the CSG Executive Committee for consideration (attached as Exhibit J):

1. Resolution Supporting Education Reforms that Address Workforce Demands and Grow State Economies (as approved by CSG's Intergovernmental Affairs Committee)
2. Resolution Supporting the U.S. Armed Forces and Veterans (as approved by CSG's Intergovernmental Affairs Committee)
3. Resolution Recognizing the Value of the Electric Power Grid (as approved by CSG's Intergovernmental Affairs Committee)
4. Resolution on Sales Tax Collection and E-Commerce Transactions (as approved by CSG's Intergovernmental Affairs Committee)

5. Resolution Supporting Intergovernmental Collaboration on Cybersecurity (as approved by CSG's Intergovernmental Affairs Committee)

6. Resolution on Eliminating Human Trafficking (as approved by CSG's International Committee)

Rep. Godfrey moved to adopt the five policy resolutions approved by CSG's Intergovernmental Affairs Committee and the resolutions were unanimously approved.

Sen. Gary Stevens moved to adopt the policy resolution approved by CSG's International Committee and the resolution was unanimously approved.

VII. ELECTON OF CSG 2016 NATIONAL OFFICERS

Mr. Adkins reported on the slate of national officers for CSG 2016. The proposed slate of officers included:

- President – Governor Jack Markell, Delaware
- Chair – Senator Beau McCoy, Nebraska
- Chair-Elect – Senator Kelvin Atkinson, Nevada
- President-Elect - vacant
- Vice Chair – Senate President Robert Stivers, Kentucky
- Vice President - Vacant
- Immediate Past Chair – Senator Carl Marcellino
- Immediate Past President – Governor Brian Sandoval, Nevada

Rep. Koppelman made a motion to approve the proposed slate of officers for 2016; it was seconded and the slate was unanimously approved.

VIII. SPECIAL RECOGNITIONS

Chair Marcellino called on Mr. Adkins for special recognition of members as follows:

- Liz Alvey, senior policy advisor to Tennessee Senator Mark Norris, for her vision and collaboration with CSG in the planning and execution of the CSG 2015 National Conference.
- Senate President Robert Stivers, incoming CSG Vice-Chair, was recognized with CSG's National Award of Merit for the pivotal role he played in the appropriation of funds and successful renovation of CSG's National Headquarters in Lexington, Kentucky.
- Rep. Bobby Moak, long-time chair of the SSL Committee and member of CSG's first Toll Fellows class in 1986, was awarded CSG's highest honor, the Distinguished Service to the States Award, for his leadership and service to CSG over the last 30 years.

- Chair Marcellino awarded Sen. Mark Norris, CSG immediate past chair, CSG's highest award, the Distinguished Service to the States Award, for leadership during his service in CSG's national officer rotation, including the launch of CSG's Federalism Task Force and the creation of the State Pathways to Prosperity Initiative.

IX. OTHER BUSINESS

Chair Marcellino called for other business. Sen. Davis presented Rep. Moak with the signage from the SSL Committee that included committee member's well wishes. Sen. Davis welcomed committee members and guests to sign the gift.

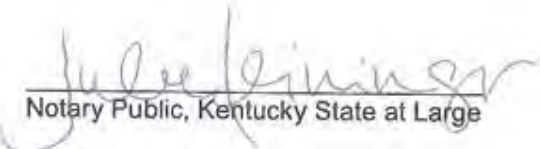
X. ADJOURNMENT

Chair Marcellino made closing remarks, passed the gavel to Chair-Elect Sen. McCoy and the meeting was adjourned at 12:37 p.m.

State of Kentucky)
)SS;
County of Fayette)

I certify that the attached meeting summary of The Council of State Governments' Executive Committee, held at its National Conference in Nashville, Tennessee dated December 13, 2015 is a true, correct and complete copy.

In witness whereof, I hereunto set my hand and official seal.


Notary Public, Kentucky State at Large

My Commission Expires: MARCH 26, 2019

Notary ID # 529378

Attachment 8

Copy of CSG's Articles of Organization

THE COUNCIL OF STATE GOVERNMENTS
ARTICLES OF ORGANIZATION



Adopted December 3, 2012

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Please choose an article below.

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BACKGROUND

NATIONAL GOVERNANCE WORKING GROUP

The conversation about CSG's governance structure and processes began during the Executive Committee meeting in June 2011 and quickly emerged as a priority for then CSG National Chair Rep. Bob Godfrey of Connecticut.

"Since our founding in 1933, CSG has seen unprecedented change in America's states, and today's fiscal and policy challenges require us as an organization to look inward and reflect on the ways CSG can better connect with state leaders around the country as they wrestle with these tough issues," said Godfrey.

Following the June meeting, a National Governance Working Group was created to examine key ways CSG could advance its mission through enhancements to its governance structure. The National Governance Working Group was composed of members from across the broader CSG organization, including state officials from each of CSG's regions as well as representatives from CSG's Affiliate and Associate communities.

Meeting twice in late 2011, and continuing its work throughout 2012, the National Governance Working Group established broad goals for enhancing CSG's governance model, including:

- An enhanced role for the judicial branch in CSG's leadership and governance structure, affirming CSG's interbranch mission
- An expanded Governing Board whose membership would include all governors, majority and minority legislative leaders, and all chief judges in member jurisdictions
- An Executive Committee tasked with major oversight of CSG activities including budget and major policy decisions
- An agile and responsive Leadership Council charged with casting the strategic vision for CSG and acting, along with CSG's senior staff leaders, as a "quick reaction force" to urgent organizational matters
- Codification of many CSG practices into officially sanctioned processes, including the regional rotation of CSG's leadership

In early 2012 a Governance Drafting Team was developed to put pen to paper on the Working Group's broad recommendations and met several times to craft a revised set of CSG governance documents. Following these meetings – and with oversight from the larger Working Group – the Drafting Team made significant progress on adjustments to CSG's governance structure and processes. During the CSG Executive Committee meeting in May 2012, the Working Group submitted its draft revisions to the CSG leadership for review.

Following this session, Drafting Team members also met with leaders from each of CSG's regions during their annual meetings during the summer of 2012. These sessions provided valuable insights into the proposed changes and Drafting Team members made several modifications to the proposal based on this feedback.

Working Group/Drafting Team

During the CSG Executive Committee meeting in June 2011, CSG leaders authorized then CSG National Chair Rep. Bob Godfrey to create a special national working group to examine CSG's governance model and offer recommendations for enhancing CSG's engagement with state leaders.

- Chair Godfrey appointed the following members to serve on the new national working group:
- Albert Ashwood, director, Oklahoma Department of Emergency Management
- Rep. Rosie Berger, Wyoming House of Representatives
- Rep. Pat Colloton, Kansas House of Representatives
- Sen. Bart Davis, Idaho Senate Majority Leader
- Sen. Jay Emler, Kansas Senate Majority Leader
- Deputy Speaker Bob Godfrey, Connecticut House of Representatives
- Pat Hayes, The Procter & Gamble Company
- Nancy Hublar, Golden Living
- Treasurer James Lewis, State of New Mexico
- Randy Morris, Bureau Chief, Dept. of Administration, Div. of State Personnel, Montana
- Sen. Mark Norris, Tennessee Senate Majority Leader
- Sen. Curren Price, California State Senate
- Chief Justice Nancy M. Saitta, Nevada Supreme Court
- Senate President Gary Stevens, Alaska State Senate
- Paul White, 1991 CSG Chair

Recommendations from the working group were considered by a drafting team appointed over the winter of 2011–12. The drafting team is composed of:

- Rep. Pat Colloton, Kansas House of Representatives
- Sen. Bart Davis, Idaho Senate Majority Leader
- Sen. Jay Emler, Kansas Senate Majority Leader
- Deputy Speaker Bob Godfrey, Connecticut House of Representatives
- Treasurer James Lewis, State of New Mexico
- Sen. Mark Norris, Tennessee Senate Majority Leader
- Sen. Gary Stevens, Alaska Senate President

ARTICLE I

NAME, PURPOSE & MEMBERSHIP

SECTION 1

Name, Principal Office, Registered Agent

The name of this organization is The Council of State Governments ("CSG"). CSG will maintain its headquarters office in Lexington, Kentucky. CSG's registered agent at that address will be its Executive Director.

SECTION 2

Purpose

The Council of State Governments, the multi-branch organization of the states and U.S. territories, champions excellence in state government, bringing state leaders from across the nation and through its regions together to put the best ideas and solutions into practice. To this end, CSG: builds leadership skills to improve decision-making; advocates multistate problem-solving and partnerships; fosters collaboration and understanding among and between the branches of government; interprets changing national and international conditions to better prepare states for the future; advances the exchange of ideas and information among state governments and their subnational counterparts in other countries; provides opportunities for public- and private-sector leaders to interact on public policy issues; and promotes the sovereignty of the states and advocates their interests in the American federal system. CSG is organized exclusively for charitable, religious, educational, and scientific purposes as permitted under section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future federal tax code and will be operated as such. No part of the net earnings of CSG will inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons, except that CSG will be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes set forth in these Articles.

SECTION 3

Membership

The membership of CSG will comprise the states of the United States, District of Columbia, Commonwealth of Puerto Rico, Territory of American Samoa, Territory of Guam, Territory of the U.S. Virgin Islands, and Commonwealth of the Northern Mariana Islands, hereinafter referred to as member jurisdictions. Wherever the word "state" or "states" appears herein, it will be meant to reference a state, commonwealth, federal district and/or territory.

SECTION 4

Participation by Member Jurisdictions

CSG, as the community of the states, respects and acknowledges the authority of state leaders to determine and appoint delegates to represent their jurisdiction on the CSG Governing Board, CSG Executive Committee, CSG Leadership Council, CSG's Standing Committees and CSG's Public Policy Committees.

The following state leaders will be recognized as the appropriate authorities responsible for making such appointments:

- A. Executive Branch—governor of each member jurisdiction or other state-wide elected official whose jurisdiction covers the appointed participant;
- B. Legislative Branch—the highest ranking legislative leader elected by each legislative chamber from each member jurisdiction; and
- C. Judicial Branch—the highest ranking judicial official from each member jurisdiction.

SECTION 5

International Partners

Subnational state, provincial or territorial governments in other countries may, subject to the review, approval and conditions set by the CSG Executive Committee, participate with CSG as "International Partners."

SECTION 6

Authority, Procedures and Rules

CSG will conduct its business in accordance with these Articles and other authorized governance documents. In all other respects, the CSG Governing Board, the CSG Executive Committee, the CSG Leadership Council and CSG's Standing Committees and Public Policy Committees will adhere to Robert's Rules of Order when conducting business. Relying on Robert's Rules of Order, CSG's General Counsel or other designee of the CSG Executive Director will serve as Parliamentarian.

ARTICLE II

FUNCTIONS

SECTION 1

Functions

CSG will be a community of the states. Its function will be to enhance the governance of its member jurisdictions by serving as a neutral, non-partisan convener of state officials and provide forums for a diverse, civil and productive engagement among state leaders of all political parties and ideological perspectives. To that end, CSG will, to the extent its resources allow:

- A. Serve as a catalyst to express the views of the member jurisdictions on matters of major concern, including state-federal issues;
- B. Act as a coordinating agency to analyze legislation and programs of the federal government and for advancing the role of the member jurisdictions in state-federal relations;
- C. Work in concert with organizations of city, county, and state officials and with federal agencies for effective intergovernmental and interbranch cooperation;
- D. Engage in research on major issues and challenges facing state government and develop programs to enhance governance of the member jurisdictions;
- E. Study techniques of state administration in order to improve governmental processes and administrative management;
- F. Arrange and convene meetings and provide other services requested by legislators, executive officials, judicial officials,

and commissions on interstate and interbranch cooperation, and their staff;

- G. Promote more effective regional cooperation, the development of programs of mutual interest to adjacent member jurisdictions, and the solution of problems common to an area;
- H. Provide programs for the training and development of state officials, legislators, judges;
- I. Gather, analyze, and disseminate information, including data on governmental policies, innovations, practices, legislation, transformations, and other items of interest to member jurisdictions;
- J. Serve as a resource for affiliated organizations, legislative service agencies of the member jurisdictions, and the news media; and
- K. Act as a catalyst for cooperation of member jurisdictions with foreign governments and their political subdivisions.

ARTICLE III

CSG GOVERNING BOARD

SECTION 1

Membership

The CSG Governing Board will be composed of the fifty-six member jurisdictions represented by the following delegates from each member jurisdiction:

- A. Executive—the Governor.
- B. Legislative —
 - 1. the two highest ranking majority party legislative leaders and the highest ranking minority party legislative leader of each legislative chamber from each member jurisdiction or their designees; or
 - 2. the legislative leader, or their designee, plus five legislators designated by the legislative leader in member jurisdictions with a non-partisan, unicameral legislature; or
 - 3. the legislative leader, or their designee, plus two legislators designated by the legislative leader in a legislative chamber that lacks majority and/or minority parties.
- C. Judicial—the highest ranking judicial official.
- D. All other CSG Executive Committee members entitled to vote.

SECTION 2

Term, Appointments and Vacancies

CSG Governing Board appointments will be made biennially for a two-year term beginning January 1 of odd numbered years. Delegates to CSG's Governing Board serve at the pleasure of their designated appointing authority.

SECTION 3

Voting and Quorum

In any action of the CSG Governing Board, the votes will be taken by member jurisdiction, with each member jurisdiction having one vote. A quorum will consist of thirty member jurisdictions present and voting. No member jurisdiction or delegate thereof may vote by a proxy. A member jurisdiction will be considered present for purposes of calculating a quorum if at least one delegate of that jurisdiction is present and eligible to vote. A member jurisdiction's vote on any matter will be determined by a majority vote of that jurisdiction's delegates present and voting.

SECTION 4

Meetings

The CSG Governing Board will be convened at the call of the CSG Executive Committee, or upon written request from CSG Governing Board members representing no fewer than thirty member jurisdictions. The CSG Governing Board will not act on any motion without prior written notice to all member jurisdictions.

SECTION 5

Powers and Duties

The CSG Governing Board will have sole jurisdiction over the dissolution of CSG or its corporate merger with another entity. The CSG Executive Committee may refer other issues to the CSG Governing Board for consideration. No other matters will be in order.

ARTICLE IV

CSG EXECUTIVE COMMITTEE

SECTION 1

Membership

The CSG Executive Committee will be composed of the following persons:

- A. CSG National Chair, CSG National President, CSG National Chair-Elect, CSG National President-Elect, CSG National Vice Chair, CSG National Vice President, CSG National Immediate Past Chair and CSG National Immediate Past President.
- B. The chairs and immediate past chairs of each of CSG's four regions.
- C. Eight Legislators, two from each of CSG's four regions, designated by the region's governing authority.
- D. One Chief Justice of a member jurisdiction.
- E. One state court administrator of a member jurisdiction.
- F. Two Lieutenant Governors or other official second in line of gubernatorial succession designated by the National Lieutenant Governors Association.
- G. Two Secretaries of State designated by the National Association of Secretaries of State.
- H. Two State Treasurers designated by the National Association of State Treasurers.

- I. Two Attorneys General designated by the National Association of Attorneys General.
- J. Four Legislators designated by the National Conference of State Legislatures.
- K. The chair or co-chairs of each CSG Standing and Public Policy Committee.
- L. Two members of the board of directors of the CSG Justice Center, as designated by the chair of the CSG Justice Center Board of Directors.
- M. Two representatives from CSG's Affiliate organizations, from among those CSG Affiliates not otherwise represented on the CSG Executive Committee, appointed by the CSG National Chair.
- N. One member of state legislative staff from each of CSG's four regions appointed by that region's governing authority.
- O. All CSG Past National Chairs and CSG Past National Presidents, so long as they are an elected or appointed state official.
- P. The CSG National Chair may appoint up to ten additional elected or appointed state officials in order to enhance diversity, inclusion, geographic or partisan balance.
- Q. The CSG National Chair may appoint up to two non-voting representatives from among CSG's International Partners.

SECTION 2

Term, Appointments and Vacancies

Appointments to the CSG Executive Committee will be for a one-year term, beginning January 1. Persons, organizations or other entities responsible for appointing persons to the CSG Executive Committee will make such appointments no later than April 1 of each year. The CSG National Chair may extend this deadline when warranted. Delegates to CSG's Executive Committee serve at the pleasure of their appointing authority.

SECTION 3

Officers and Authority

The officers of CSG will include the CSG National Chair, CSG National Chair-Elect, CSG National Vice Chair, CSG Immediate Past National Chair, CSG National President, CSG National President-Elect, CSG National Vice President, and CSG Immediate Past National President. All CSG officers will serve as officers of CSG's Governing Board, CSG's Executive Committee, and CSG's Leadership Council.

- A. **Qualifications:** The CSG National Chair, CSG National Chair-Elect, CSG National Vice Chair, and CSG Immediate Past National Chair will be incumbent legislators representing CSG member jurisdictions. The CSG National President, CSG National President-Elect, CSG National Vice President, and CSG Immediate Past National President will be incumbent governors or other jurisdiction-wide elected officials representing CSG member jurisdictions.
- B. **Terms of Office:** All officers will serve one-year terms beginning on January 1.
- C. **Nominations and Elections:** The offices of CSG Immediate Past National Chair and CSG Immediate Past National President will be filled by automatic succession. All other CSG officers will be elected annually by the CSG Executive Committee during

the CSG National Annual Meeting, or at such other time as designated by the CSG Executive Committee. Written notice of any alternate date will be provided to the CSG Executive Committee at least thirty days in advance. Candidates for election to serve as CSG officers will be nominated by the CSG Leadership Council, as provided herein. The CSG Leadership Council will forward to the CSG Executive Committee a nominee for each national office. A CSG Executive Committee member may submit other nominations with at least three calendar days prior written notice to the CSG National Chair and CSG National President so long as such nominees are from the same CSG region as the nominee of the CSG Leadership Council.

- D. **Regional Nomination and Rotation of Legislative Officers:** The regional designation of a nominee for CSG National Chair, National Chair-Elect and National Vice Chair will rotate annually in the following order, beginning January 1, 2013: National Chair—CSG-West; National Chair-Elect—CSG-South; National Vice Chair—CSG-East; and Immediate Past National Chair—CSG-Midwest. The appropriate CSG region will designate a qualified nominee from among its member jurisdictions to serve as the next CSG National Vice-Chair in accordance with its own rules, provided such designation is made at least two weeks prior to the CSG Executive Committee meeting at which consideration of such nomination is scheduled. The designated nominee will be nominated by the CSG Leadership Council to the CSG Executive Committee. In the event that a CSG region fails to timely recommend a nominee, the CSG Leadership Council will nominate a candidate from that region after consulting with that region's officers. CSG officers serving in the positions of CSG National Chair-Elect and CSG National Vice Chair will be nominated by the CSG Leadership Council for election to the positions of CSG National Chair and CSG National Chair-Elect, respectively.
- E. **Vacancies:** In the event that a CSG officer or nominee resigns, is ineligible or declines to serve, the office held or nomination will be vacated. In the event of a vacancy in the office of CSG National Chair, the duties of CSG National Chair will be performed by the officer next in line of succession. In the event of a vacancy in the office of CSG National President, the duties of CSG National President will be performed by the officer next in line of succession. In the event of a vacancy in the office of CSG National Chair, CSG National Chair-Elect or CSG National Vice Chair, the CSG Leadership Council will request that the appropriate region designate a nominee to fill the vacancy, in accordance with its own rules. A nominee designated by the region will be reported to, and nominated by, the CSG Leadership Council.
- F. **Removal from Office:** With prior written notice and an opportunity to be heard, any CSG officer may be removed from office by a two-thirds vote of the members present and voting at any CSG Executive Committee meeting.

SECTION 4

Duties of Officers

The CSG National Chair will preside at all meetings of the CSG Executive Committee and CSG Leadership Council. The CSG National Chair-Elect will serve as CSG Acting National Chair in the absence of the CSG National Chair. In the absence of the CSG

National Chair and CSG National Chair-Elect, the CSG National Vice Chair will serve as CSG Acting National Chair. The CSG National President will preside at meetings of the CSG Governing Board, maintain general responsibility for CSG's Annual Meeting, and represent CSG at regional or national meetings. The CSG National President-Elect will serve as CSG Acting National President in the absence of the CSG National President. In the absence of the CSG National President and CSG National President-Elect, the CSG National Vice President will serve as CSG Acting National President. In the absence of the CSG National President, CSG National President-Elect, and CSG National Vice President, the CSG National Chair, CSG National Chair-Elect or the CSG National Vice Chair may perform the functions of the CSG National President. In the absence of the CSG National Chair, CSG National Chair-Elect or the CSG National Vice Chair, the CSG National President, CSG National President-Elect or the CSG National Vice President may perform the functions of the CSG National Chair. The CSG National officers will perform such other duties as approved by the CSG Governing Board, CSG Executive Committee, CSG Leadership Council and these Articles.

SECTION 5

Voting and Quorum

A quorum for the purpose of conducting business will consist of those members present; except, a quorum for the purpose of adopting policy resolutions, adjusting member jurisdiction dues, imposing sanctions for non-payment of dues, convening the CSG Governing Board, reassigning a member jurisdiction from one region to another and reversing an action of the CSG Leadership Council will consist of twenty-five members of the CSG Executive Committee. No votes may be cast by proxy.

SECTION 6

Meetings

The CSG Executive Committee will meet at the call of the CSG National Chair, but at least once annually, or upon a written request from at least twenty-five CSG Executive Committee members, either in person or by sanctioned electronic means. The CSG Executive Committee will not meet without prior written notice to the members.

SECTION 7

Powers and Duties

Except as otherwise provided in these Articles, the CSG Executive Committee will have general authority over the funds, property, and management of CSG, including to:

- A. Establish 'Policy Resolution Guidelines' prescribing the types and nature of policy resolutions or statements that place CSG on public record with regard to a matter of local, state or federal policy. All CSG policy statements and resolutions not updated or renewed within three years from the date of adoption will expire, unless an earlier expiration is otherwise provided in the policy statement or resolution;
- B. Consider, approve or rescind statements of policy that represent the official policy position of CSG;
- C. Consider, approve or rescind statements of policy adopted on an Interim basis by the CSG Leadership Council;
- D. Consider, adopt or amend CSG's annual operating budget and

review and approve all interim budget decisions made by the CSG Leadership Council;

- E. Adopt financial management rules governing the submission of budget recommendations, investment of CSG funds and financial controls;
- F. Determine an equitable dues allocation formula for the member jurisdictions, advocate for the payment thereof and impose appropriate sanctions on any non-dues paying member jurisdictions;
- G. Appoint and assign responsibilities to the CSG Executive Director;
- H. Amend the regional structure of CSG as provided herein;
- I. Consider and approve the terms and conditions of participation by foreign nations and their political subdivisions;
- J. Consider and approve the terms and conditions of participation by private-sector entities and their representatives;
- K. Call meetings of the CSG Governing Board;
- L. Delegate to the CSG Leadership Council, for a time certain, authority to exercise CSG Executive Committee powers; and
- M. Veto any action authorized or undertaken by the CSG Leadership Council, except as provided under Article V, Section 3.

All powers, functions, and duties not otherwise delegated herein, are reserved to the CSG Executive Committee.

SECTION 8

CSG Executive Director

A. Responsibilities: The CSG Executive Director:

1. Serves as the chief executive officer of CSG responsible for all management functions. The CSG Executive Director is responsible for directing CSG activities and programs, including day-to-day operations of CSG, and carrying out CSG's strategic mission under the direction of CSG's officers, the CSG Leadership Council, the CSG Executive Committee and the CSG Governing Board.
2. Serves as the Secretary of CSG and will designate a Treasurer for CSG.
3. Establishes, pursuant to Article IX, the terms and conditions of an affiliation by and between CSG and another association provided the mission and purpose of that association is compatible with and advances the mission and purpose of CSG.
4. Serves as CSG's staff liaison to other associations of state and local government officials.
5. Serves as President of CSG's 21st Century Foundation.
6. Employs, discharges and establishes the terms and conditions of employment of all CSG employees, except CSG Regional Directors and Affiliate Directors and employees of same.
7. Establishes, after consultation with the Regional Directors and the directors of CSG's affiliated organizations, the human resource policies for all CSG employees, and establishes the financial, accounting, information technology and other administrative policies and procedures for CSG.

- B. Appointment and Compensation: The CSG Leadership Council will establish the terms and conditions of the employment contract for the CSG Executive Director and provide for the annual performance evaluation of the CSG Executive Director. Any action to employ or discharge a CSG Executive Director will require the affirmative vote of at least two-thirds of the members of the CSG Leadership Council. A CSG Leadership Council action to employ or discharge the CSG Executive Director will be conveyed in writing to the members of the CSG Executive Committee and the CSG Executive Committee may amend, repeal or affirm such action upon a majority vote.
- C. Deputy Executive Directors: The Regional Director of each CSG region will also serve as a Deputy Executive Director of CSG. In this role they will consult and collaborate with the CSG Executive Director in support of the mission and goals of CSG. The CSG Executive Director may appoint such other Deputy Executive Directors as appropriate.

ARTICLE V

CSG LEADERSHIP COUNCIL

SECTION 1

Membership

The CSG Leadership Council will be composed as follows:

- A. CSG National Chair
- B. CSG National President
- C. CSG National Chair-Elect
- D. CSG National Vice Chair
- E. CSG Immediate Past National Chair
- F. CSG Immediate Past National President
- G. CSG Regional Chair or their designees; one from each of CSG's four (4) regions
- H. One member appointed by the National Lieutenant Governors Association
- I. One member appointed by the National Association of State Treasurers
- J. One member appointed by and representing CSG's Affiliated organizations
- K. Chair of the CSG Justice Center Board of Directors or designee
- L. One CSG Finance Committee member appointed by the CSG National Chair
- M. One CSG Intergovernmental Affairs Committee member appointed by the CSG National Chair
- N. One CSG Interbranch Affairs Committee member appointed by the CSG National Chair

SECTION 2

Term, Appointments and Vacancies

CSG Leadership Council appointments will be made annually for a one-year term, beginning on January 1. Persons, organizations

or other entities responsible for appointing persons to the CSG Leadership Council will make such appointments no later than February 1 of each year. The CSG National Chair may extend this deadline when warranted. Members of CSG's Leadership Council serve at the pleasure of their appointing authority. Members of CSG's Leadership Council shall carry out their duties as leaders of CSG and exercise such duties not as a representative of their appointing authority, but in the best interests of CSG.

SECTION 3

Exclusive Powers and Duties

The CSG Leadership Council will establish the terms and conditions of the employment contract for the CSG Executive Director and provide for the annual performance evaluation of the CSG Executive Director.

SECTION 4

Provisional Powers and Duties

The CSG Leadership Council will:

- A. Establish the official policies, approve the acquisition, transfer or sale of any interest in real property, and confirm or cancel legal contracts or obligations referred to it by the CSG Executive Director. Such actions will be reported to the CSG Executive Committee within three business days by the CSG Executive Director and the CSG Executive Committee may, by a majority vote, reverse such a decision by the CSG Leadership Council within ten business days of receiving the report; and
- B. Authorize the initiation, defense or settlement of legal claims or potential legal claims. Such actions will be reported to the CSG Executive Committee within three business days by the CSG Executive Director and the CSG Executive Committee may, by a majority vote, reverse such a decision by the CSG Leadership Council within ten business days of receiving the report;

SECTION 5

Other Powers and Duties

The CSG Leadership Council will:

- A. Consider and adopt any interim statements of policy which will expire at the next meeting of the CSG Executive Committee unless affirmed by the CSG Executive Committee;
- B. Create Public Policy Committees as may be necessary to advance of the mission of CSG;
- C. Engage in strategic planning, including approval of CSG's mission and vision. The CSG Leadership Council will establish strategic priorities for CSG's products, programs and services, and provide a report to the CSG Executive Committee;
- D. Consider and approve interim changes to the annual operating budget, subject to approval of the CSG Executive Committee;
- E. Adopt guidelines for the affiliation of associations with CSG;
- F. Review appropriate financial reports including CSG's IRS Form 990 prior to filing and all reports of auditors; and
- G. Take other interim actions necessary to govern CSG, subject to review by the CSG Executive Committee.

SECTION 6

Voting

Each member of the CSG Leadership Council will be entitled to one vote. No vote may be cast by a proxy.

SECTION 7

Meetings

The CSG Leadership Council will meet at the call of the CSG National Chair or upon the petition of one-third of its members, either in person or by sanctioned electronic means.

SECTION 8

Quorum

A majority of the members will constitute a quorum for conducting business of the CSG Leadership Council.

ARTICLE VI

CSG STANDING AND PUBLIC POLICY COMMITTEES

SECTION 1

Standing Committees

A. To conduct business on behalf of the organization and to fulfill its purpose, CSG will maintain the following the Standing Committees:

1. Finance Committee: The Finance Committee will monitor the fiscal affairs of CSG, review the financial implications of proposed plans before implementation, and recommend an annual budget and schedule of state appropriations to the CSG Executive Committee. In its role of providing financial oversight, the Finance Committee serves as fiduciary, maintaining financial management rules for CSG. The membership of the Finance Committee will include public-sector members only and will consist of: the chair and chair elect (or vice chair in regions having no chair elect) of each CSG region; one member from each region designated by the chair of each region; four members at large designated by the CSG National Chair; up to four members of CSG Affiliate organizations represented on the CSG Executive Committee to be designated by the CSG National Chair; two advisors (non voting), one each representing the executive and legislative branches of state government; and a chair and vice chair of the Finance Committee to be designated by the CSG National Chair and CSG National Chair-Elect.
2. Intergovernmental Affairs Committee: the Intergovernmental Affairs Committee will review and monitor major intergovernmental issues and relevant court cases and decisions impacting the states. The Intergovernmental Affairs Committee will review all policy positions or resolutions approved by CSG's Public Policy Committees and may recommend these and other resolutions and policy statements to the CSG Executive Committee. The Intergovernmental Affairs Committee will periodically review and update its resolutions and policy statements and request other committees to review and update

theirs as necessary. The membership of the Intergovernmental Affairs Committee will be appointed bi-annually by the CSG National Chair, and will include two members from each CSG region and one member from each CSG affiliate organization. Membership may include non-voting private-sector representatives from CSG's Associates Program and non-voting representatives from CSG International Partners as designated by the CSG National Chair. The CSG National Chair, in consultation with the CSG National Chair-Elect, will appoint two Intergovernmental Affairs Committee Co-Chairs or a Chair and Vice Chair.

3. Interbranch Affairs Committee: the Interbranch Affairs Committee will review and monitor major interbranch issues and seek to foster collaboration and understanding among and between the branches of state government. The membership of the Interbranch Affairs Committee will be appointed bi-annually by the CSG National Chair in consultation with the CSG Leadership Council and will include public-sector members from CSG member jurisdictions and may include non-voting representatives from International Partners as designated by the CSG National Chair. The CSG National Chair, in consultation with the CSG National Chair-Elect, will appoint three Interbranch Affairs Committee Co-Chairs, one from each branch of state government.
4. Suggested State Legislation (SSL) Committee: With the goal of sharing innovations in state governance, the SSL Committee will identify, review and disseminate state legislation on topics of major interest. The consideration or dissemination of such legislation will not constitute an endorsement nor will CSG advocate for the enactment of any such legislation in any member jurisdictions. The SSL Committee's membership will include public-sector members only and will include one member from each legislative chamber in each member jurisdiction; or two legislative members from a unicameral legislature; and one legislative staff member from each member jurisdiction appointed by the CSG National Chair from recommendations of the appropriate legislative appointing authorities in the member jurisdictions. The CSG National Chair and CSG National Chair-Elect will appoint the SSL Committee Co-Chairs or one Chair and Vice Chair. The Chair or Co-Chairs will be legislators and the Vice Chair will be legislative staff. Five members present and voting will constitute a quorum for conducting business of the SSL Committee. Any replacement of a SSL Committee member by a member jurisdiction's legislative appointing authority or the appointment of a proxy will be made no later than two weeks prior to the date of any SSL Committee meeting for that member to be eligible to participate at that meeting.
5. National Meetings Committee: The National Meetings Committee will coordinate and recommend the dates and locations for CSG's national meetings. The National Meetings Committee will seek bids from member jurisdictions to host a meeting at least one year, and preferably two to three years, in advance and make recommendations to the CSG Executive Committee

for future sites and dates of CSG national meetings. The membership of the National Meetings Committee will be appointed by the CSG National Chair and will include, but is not limited to, the CSG National President and CSG National Chair, representatives of the three past host jurisdictions, one representative from each of CSG's four regions and non-voting representation from CSG's Associates Program. The CSG National Chair, in consultation with the CSG National Chair-Elect, will appoint the National Meetings Committee Co-Chairs or Chair and Vice Chair. Committee members representing a member jurisdiction competing for selection will not be eligible to vote on any question arising in the course of such consideration.

6. **International Committee:** the International Committee will be responsible for coordination and development of activities in the international arena of importance to U.S. states. Those activities will include, as appropriate, coordination of exchanges and discussions between U.S. state and foreign government officials; development and oversight of research and other projects involving international issues and concerns; coordination of international activities involving more than one CSG region or affiliate; and development of special meetings and symposia on appropriate international issues of importance to state governments. Membership of the International Committee will consist of legislators and other elected and appointed state officials from all areas of the United States, appointed by the CSG National Chair and to include members from all CSG regions. Membership may also include non-voting representatives from CSG's Associates Program. All CSG International Partners designated by the CSG Executive Committee will be entitled to one voting member on the International Committee as appointed by the highest elected official of that subnational government and subject to approval by the CSG National Chair. The CSG National Chair, in consultation with the CSG National Chair-Elect, will appoint the International Committee Co-Chairs or Chair and Vice Chair. Members of the CSG Global Associates Program will serve as non-voting members.
7. **CSG Associates Advisory Committee:** The CSG Associates Advisory Committee will work to marshal private-sector support of CSG's mission of service to the states. It will cultivate meaningful partnerships between CSG and private-sector entities and promote excellence in state government and sound public policy. The Committee will be chaired by the CSG National Chair-Elect and the CSG Immediate Past National Chair will serve as Vice Chair. The CSG National Chair, in consultation with the CSG National Chair-Elect, will appoint the members of the committee. All members of the committee will be entitled to one vote on matters coming before the committee. A majority of the committee members will be public-sector representatives of member jurisdictions.
- B. **Standing Committee Membership:** Unless otherwise noted or provided for by the CSG Executive Committee, only representatives from CSG member jurisdictions will be eligible to serve on CSG Standing Committees. Appoint-

ments to CSG Standing Committees will be made biennially for a two-year term beginning January 1, and, provided all appointees serve at the pleasure of their appointing authority. Appointments to a CSG Standing Committee made during the two-year term will expire at the conclusion of the biennium. A proxy may be recognized upon written authorization from the appropriate state appointing authority. In order to be valid, such proxy must be presented to the appropriate Standing Committee Chair or Co-Chairs prior to the call to order of any meeting. CSG does not recognize proxies granted solely by Standing Committee members. CSG's National Officers, Past National Chairs and CSG Past National Presidents will be ex officio, voting members of all CSG Standing Committees so long as they remain a state official. CSG's National Officers, CSG Past National Chairs and CSG Past National Presidents not in attendance at a CSG Standing Committee meeting will not be included when counting to determine the presence of a quorum.

- C. **Standing Committee Voting and Quorum:** Except as otherwise noted in this Article, each member of a CSG Standing Committee will be entitled to one vote. No vote may be cast by a proxy. At any meeting of a CSG Standing Committee the presence (either physical or through sanctioned electronic means) of Committee members representing greater than one-fourth of the total CSG member jurisdictions with appointments to the Committee will constitute a quorum.
- D. **Standing Committee Meetings and Notice:** CSG Standing Committees will meet on the call of the Standing Committee Chair or Co-Chairs or the CSG National Chair. All Standing Committee members will be provided two-weeks notice of any proposed policy positions or resolutions to be considered at a meeting of the committee. No Standing Committee may waive the two week prior notification rule.

SECTION 2

Public Policy Committees

The CSG Leadership Council, subject to the review of the CSG Executive Committee, will create such Public Policy Committees and designate such members to committees as may be necessary to advance the mission of CSG. Public Policy Committees will exist for the biennium, unless renewed.

- A. **Public Policy Committee Membership:** CSG Public Policy Committee membership may include both public-sector representatives from CSG's member jurisdictions, non-voting representatives from CSG's International Partners and private-sector, non-voting representatives from CSG's Associates Program. Public-sector appointments to CSG Public Policy Committees will be made biennially for a two-year term provided all appointees serve at the pleasure of the appropriate state appointing authority. Appointments to a CSG Public Policy Committee made during the two-year term will expire at the conclusion of the biennium. Terms of private-sector members will be for one-year. Private-sector membership on any Public Policy Committee may not exceed twenty-five percent of the total committee membership roster. A public-sector member's proxy may be recognized upon written authorization from the appropriate state appointing authority. In order to be valid, such a proxy must be presented to the appropriate Public Policy

Committee Chair or Co-Chairs prior to the call to order of any meeting. CSG does not recognize proxies granted solely by Public Policy Committee members. Private-sector non-voting representatives to Public Policy Committees will be appointed by the CSG National Chair from among the members in good standing of CSG's Associates Program. CSG's National Officers, Past National Chairs and CSG Past National Presidents will be ex officio, voting members of all CSG Standing Committees so long as they remain a state official. CSG's National Officers, CSG Past National Chairs and CSG Past National Presidents not in attendance at a CSG Standing Committee meeting will not be included when counting to determine the presence of a quorum.

- B. **Policy Committee Voting and Quorum:** Except as otherwise noted in this Article, each public-sector member of a CSG Public Policy Committee will be entitled to one vote. At any meeting of a CSG Public Policy Committee the presence (either physical or through sanctioned electronic means) of public-sector committee members representing greater than one-fourth of the total CSG member jurisdictions with appointments to the committee will constitute a quorum.
- C. **Public Policy Committee Meetings and Notice:** CSG Public Policy Committees will meet at the call of the Public Policy Committee Chair or Co-Chairs or the CSG National Chair. All Public Policy Committee members will be provided two-weeks notice of any proposed policy positions or resolutions to be considered at a meeting of the committee. No Public Policy Committee may waive the two week notification rule.

ARTICLE VII

REGIONAL ORGANIZATION

SECTION 1

CSG Regions

CSG will have four regions to foster a greater understanding of issues unique to each region and to provide a regionally based forum for state officials. Each region will be governed by a governing authority established pursuant to that region's enacted governing documents. A region may exercise such duties and powers not in conflict with or otherwise prohibited in these Articles.

SECTION 2

Regional Rules

- A. Each CSG region will adopt governing rules including:
 - 1. Purpose Statement
 - 2. Membership
 - 3. Officers and Elections
 - 4. Executive Committee
 - 5. National Leadership Nomination Process
 - 6. Committees
 - 7. Policy Resolution Process
 - 8. Meetings

- 9. Regional Director, Staff and Annual Evaluations

- 10. Amendment Process

- B. Each CSG regional governing authority will annually approve a budget for the region which will be timely submitted to the CSG Executive Director.

SECTION 3

Regional Director

The Regional Director is an at-will employee of CSG and serves at the pleasure of the regional governing authority as specified in that region's governing documents.

- A. **Responsibilities:** Each region's Regional Director:
 - 1. Is responsible for directing regional activities and programs, including day-to-day operations of that region.
 - 2. Will serve as a Deputy Executive Director of CSG.
 - 3. Employs and discharges other CSG employees of that region.

- B. **Appointment, Compensation and Review:** Each CSG region will, pursuant to that region's governing documents:
 - 1. Appoint and assign responsibilities to a Regional Director.
 - 2. Annually review the performance of a Regional Director and provide its written review to CSG's human resources director.
 - 3. Establish compensation for a Regional Director pursuant to CSG's human resource policies.

SECTION 4

Regional Composition

Regions of CSG will comprise the following member jurisdictions:

- A. **CSG East:** Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, the Commonwealth of Puerto Rico, Rhode Island, Vermont, and the Territory of the U.S. Virgin Islands.
- B. **CSG Midwest:** Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Nebraska, North Dakota, Ohio, South Dakota, Wisconsin.
- C. **CSG South:** Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, West Virginia.
- D. **CSG West:** Alaska, the Territory of American Samoa, Arizona, California, Colorado, the Territory of Guam, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington, Wyoming, and the Commonwealth of the Northern Mariana Islands.

SECTION 5

Amendments to Regional Structure

The regional structure defined in Article VII, Section 4 will not be amended except by the affirmative vote of two-thirds of the members present and voting at a meeting of the CSG Executive Committee, as specified in Article IV, Section 5. A motion to reassign a member jurisdiction from one region to another will be in order only if endorsed in writing by that member jurisdiction's

Governor, and the highest legislative leader elected by each legislative chamber. Written notice of any proposed amendment to Article VII, Section 4 will be provided to all CSG Executive Committee members at least thirty days prior to the meeting during which the amendment is to be considered. The proposed amendment may not thereafter be further amended without similar written notice and endorsements, except by a vote of two-thirds of the members present and voting.

SECTION 6

Regional Organization and Services

The regions may render assistance to regionally focused organizations in partnership with CSG, be of assistance to individual member jurisdictions comprising the regions, and perform such other duties to advance the mission of CSG. The enumeration of member jurisdictions by regions in Article VII, Section 4 will not preclude cooperation among member jurisdictions in different regions, and regional office support to such groups of member jurisdictions will be allowed.

SECTION 7

Regional Annual Meetings

With the goal of avoiding conflicting regional annual meeting dates, the dates of each regional annual meeting will be coordinated in advance with the CSG Executive Director.

ARTICLE VIII

CSG JUSTICE CENTER

SECTION 1

Purpose

CSG will have a Justice Center whose purpose is to provide information and assistance to member jurisdictions on criminal justice and public safety matters and to advance the mission of CSG. The CSG Justice Center will be governed by a governing authority established pursuant to governing documents enacted by the CSG Justice Center with the approval of CSG's Executive Committee. The CSG Justice Center may exercise such duties and powers not otherwise in conflict with or prohibited herein.

ARTICLE IX

RELATED ORGANIZATIONS

SECTION 1

Affiliated Organizations

Upon the approval of the CSG Executive Committee, CSG is authorized to grant affiliate status to qualified petitioning organizations and may, as agreed, provide financial assistance, secretariat and other staff services to such affiliated organizations. CSG's relationships with such affiliated organizations will be defined, established and terminated by the CSG Executive Committee.

ARTICLE X

CSG ASSOCIATES PROGRAM

SECTION 1

Associates Program

CSG will have an Associates Program. The purpose of the program will be to establish meaningful partnerships between CSG and private-sector or non-governmental entities. Members of the Associates Program will pay dues in an amount established by the CSG Leadership Council to support the non-profit mission of CSG and may participate in CSG activities as provided herein or as approved by the CSG Executive Committee, so long as such approval is not in conflict with these Articles.

ARTICLE XI

CSG 21ST CENTURY FOUNDATION

SECTION 1

21st Century Foundation

The 21st Century Foundation provides funding for CSG initiatives and priorities overseen by a Board of Trustees. The 21st Century Foundation will be governed by a Board of Trustees and administered by CSG staff. The Board of Trustees will be composed of not less than thirty-five, but no more than fifty members and will include both public- and private-sector participants of which the majority will be public-sector officials. Private-sector members making qualifying contributions to the 21st Century Foundation as established by the Board of Trustees will be entitled to serve as trustees for a five-year term. The Chair of the Board of Trustees will be the CSG National Chair-Elect. The Vice Chair of the Board of Trustees will be the CSG National Vice Chair. The CSG Executive Director will act as president and chief executive officer of the 21st Century Foundation. The 21st Century Foundation will submit an annual report of its activities to the CSG Leadership Council and the CSG Executive Committee.

ARTICLE XII

CSG LEGAL TASK FORCE

SECTION 1

Legal Task Force

CSG will have an independent Legal Task Force to review litigation in federal courts that may potentially impact the states and/or impact the fundamental tenets of the American federalism system. In this role the Legal Task Force will, subject to a majority vote of its members, approve CSG's participation on amicus curiae briefs to the courts and/or join such briefs as may be submitted by other organizations. The Legal Task Force will, upon the submission or endorsement of an amicus brief, provide written notice to the CSG Leadership Council and will provide a regular written update to the CSG Leadership Council. The membership of the Legal Task Force will consist of three public-sector

members designated by each region. The CSG National Chair will appoint a chair of the Legal Task Force from among the group's membership. All appointments to the Legal Task Force will be for a two-year term beginning on January 1 of odd-numbered years. CSG, excluding CSG affiliates acting in their own name, will not approve or endorse any amicus briefs without the prior approval of the CSG Legal Task Force.

ARTICLE XIII

DISSOLUTION

SECTION 1

Distribution of Assets

In the event of the dissolution of The Council of State Governments, and following the satisfaction of all debts and liabilities in accordance with CSG's Rules for Financial Management as established by the CSG Executive Committee, any assets managed by CSG will be distributed to the member jurisdictions in the proportion to which each member jurisdiction contributed to the support of CSG during the five-year period immediately preceding dissolution. Any assets so distributed to a member jurisdiction will be used for a qualified, tax-exempt, public purpose.

ARTICLE XIV

AMENDMENTS

SECTION 1

Method

The CSG Executive Committee at any meeting may amend these Articles, unless otherwise provided herein, by a majority vote of those present, but at least one affirmative vote must be cast from not less than twenty-six member jurisdictions. Article VII, Section 4 may only be amended as provided in Article VII, Section 5. Written notice of any proposed amendment, including an explanatory statement, will be provided to all CSG Executive Committee members at least thirty days prior to the meeting at which the amendment is to be submitted to a vote. The proposed amendment may not thereafter be further amended without similar written notice, except by a vote of two-thirds of the members present and voting.

SECTION 2

Suspension

The provisions of Section 1 of this Article may only be suspended by unanimous consent of those present and voting.

Attachment 9

List of full names, last known addresses, dates of birth, social security numbers, beginning and ending dates of employment, and sick leave balances of all current and former CSG employees.

SN	Hire Date	KEES Start	Termination Date	Birth Date	First Name	Middle Name	Last Name	Sold Leave	Address 1	Address 2	City	State/Province	ZIP/Postal Code
401-21-9712	2/16/2006	2/1/2005		5/20/1977	Erin	Elizabeth	Abner	501.5	133 Windring View Trail		Georgetown	CV	40324
404-37-6730	05/16/06	6/1/2006	8/14/2006	3/7/1977	Erin	Elizabeth	Abner	4	221 Toronto Rd		Lexington	CV	40315
512-58-1150	11/1/2008	11/1/2008		4/6/1983	David		Adkins	576	350 E Short St		Lexington	CV	40507 1591
462-69-9035	11/12/2012	11/1/2012		4/6/1983	David		Adkins	116.5	221 Paddock Dr		Georgetown	CV	40383
405-15-6214	3/6/2006	3/1/2006		7/2/1964	Lisa	Page	Anderson	9	566 Duval Station Road		Georgetown	CV	40324
314-58-1964	5/1/2010	5/1/2010	8/30/2013	10/1/1952	Norman	II	Artch	209.5	1024 Birchwood Lane		Frankfort	CV	40002
401-50-1550	7/1/1998	11/1/2003	7/31/2004	11/29/1938	Charles		Baba	540	134 Cherry Hill Dr		Georgetown	CV	40002
404-25-2187	7/2/2001	12/1/2001	7/1/2006	11/5/1964	James	W	Balwin	23	205 Rachel Ct		Georgetown	CV	40324
402-11-0751	9/7/2010	9/1/2010		5/20/1976	Sabrina		Barton	162	1969 Blumore Road		Lexington	CV	40315
402-31-6698	1/29/2004	1/1/2004	02/18/05	6/27/1958	Joseph	A	Baxter	36	3241 B Marmon Dr		Lexington	CV	40502
302-50-6348	06/16/06	7/1/2006	11/24/2008	10/10/1949	Patricia	K	Beal	44	1588 Highower Dr		Columbus	OH	43235
233-90-4846	1/3/2005	1/1/2005		6/27/1958	Joseph	A	Beal	274.25	738 Chinoe Road		Georgetown	CV	40502
403-08-4562	9/23/2002	12/1/2003	9/23/2002	12/16/1971	Melissa	Taylor	Bell	292	110 Chambers Ave		Georgetown	CV	40324
403-70-2841	3/4/1996	12/1/2003	9/30/2014	8/18/1940	Wanda	Katherine	Bloch	480.5	4704 Spring Creek Drive		Lexington	CV	40515
400-35-3257	02/16/05	2/1/2005	08/23/05	2/15/1976	Buddy		Bloch	12	300 Blount Dr		Georgetown	CV	40356
353-56-8075	7/19/2004	7/1/2004	9/4/2006	8/24/1956	Mary	Shana	Bowman	12.6	102 Theorapghood Way		Georgetown	CV	40356
587-51-1646	5/15/2006	6/1/2006	11/10/2006	8/23/1969	Chris		Braun	21	520 Skyway Dr		Paris	CV	40361
404-92-4704	1/3/2006	1/1/2006	3/10/2013	11/9/1963	Mary	Luebe	Brantton	417.5	857 Conditut Drive		Frankfort	CV	40601
413-59-6837	12/14/2009	12/1/2009	8/28/2013	12/19/1964	Jack	Preson	Branton	134.25	118 E Broadway Ave		Georgetown	CV	40315
405-31-6844	10/23/2007	11/1/2007	7/23/2012	7/25/1975	Gary	I	Brannon	107	114 Bulwin Terrace		Lexington	CV	40517
405-29-8054	7/1/2010	7/1/2010	3/1/2011	8/12/1985	Kyle		Bredell	54.5	3424 Locust Dr		Berea	CV	40403
258-23-0720	9/20/2010	9/1/2010	5/3/2011	10/2/1963	Jo		Brown	80	8802 Battlefield Memorial Highway		Lexington	CV	40509
405-29-3065	1/1/2007	1/1/2007	8/30/2007	11/24/1979	C Nathan	D	Brown	24	3317 Pueblo Ct		South Bend	IN	46616
580-08-1622	10/12/2004	2/1/2005	9/12/2005	8/21/1968	Shiva		Brown	17	2516 Main Ln		Charlotte	NC	28262
402-35-1171	8/9/2006	8/1/2006	7/6/2007	11/30/1982	Nadette		Bullock	83.5	6410 Oak Road Dr		Lexington	CV	40504
375-58-4781	10/16/2012	10/1/2012	11/20/2018	5/6/1977	Wesley	Lou	Bullock	217	1732 Hockmays Dr		Lexington	CV	40517
407-46-6730	5/1/2007	5/1/2007	4/13/2010	10/16/1958	Linah	M	Bundick	293.5	188 Newport Lane		Berea	CV	40517
404-19-0521	9/26/2009	9/1/2009	5/4/2007	9/16/1981	Jacory		Burgbacher	57.2	372 Chamberlain Dr		Lexington	CV	40517
502-58-1893	09/01/05	9/1/2005	5/4/2007	5/22/1978	Janet	J	Burnett	147.5	3244 Marston Place		Lexington	CV	40517
401-35-8529	8/1/2006	8/1/2006	7/1/2008	2/27/1978	Janeen	L	Burnett	507	880 Verno Street		Lexington	CV	40508
400-31-4107	1/23/2006	2/1/2008	4/1/2007	4/24/1941	Nail	L	Burnett	64	4005 Maple Dr		Lexington	CV	40515
406-19-0899	2/13/2012	2/1/2012	6/13/2014	6/9/1960	Emily	L	Cannon	52	3232 Bushorn Dr		Lexington	CV	40502
409-90-0326	1/23/2012	1/1/2012	4/15/2014	6/19/1954	Janet	L	Cannon	10	2344 Lake Park Rd		Lexington	CV	40515
173-48-5673	8/1/2006	8/1/2006	1/22/2012	1/6/1956	Vicki	L	Cantrill	266	324 East Jackson St		Georgetown	CV	40324
407-41-7087	10/6/2014	10/1/2014	12/7/2010	7/27/1980	Thomas	Marie	Carroll	304	1177 Walnut St		Lexington	CV	40509
631-03-9152	10/1/2007	12/7/2010	1/9/2008	4/26/1964	Mimi	S	Chavers	175	3344 Warmwater Pl		Lexington	CV	40512
571-70-2708	10/1/1981	12/1/2003	1/9/2008	8/24/1961	Kevin	Lynn	Clay	328	3641 Gloucester Dr		Lexington	CV	40510
407-33-7794	9/16/2004	9/1/2004	3/17/2011	1/18/1980	Elizabeth	E	Clay	71	4008 Wingate Road		Louisville	CV	40207
405-35-6228	9/1/2006	9/1/2006	1/1/2013	1/18/1980	Marjaret		Cloyd	100	4237 Nutting Drive		Lexington	CV	40513
405-23-6612	10/24/2005	10/1/2005	12/8/2014	5/29/1972	Shannon	Conn	Cloyd	10	108 Shelby St		Frankfort	CV	40501
404-04-6142	8/20/2012	8/1/2012	12/8/2014	1/26/1966	Lisa		Coyd	30	2510 Knightbridge Ln		Lexington	CV	40509
403-35-3153	1/1/2013	1/1/2013	1/1/2014	1/18/1980	Marjaret		Coyd	100	2510 Knightbridge Ln		Lexington	CV	40509
409-06-6807	10/31/2006	11/1/2006	7/5/2007	10/3/1972	Kimberly	Alex	Cobb	352	211 Berklehem Road		Waco	CV	40385
525-71-3780	9/16/2009	9/1/2009	4/1/2010	10/28/1962	Laura	C	Coleman	37	117 Irving Ln		Georgetown	CV	40324
473-13-6534	7/15/2008	8/1/2008	7/15/2010	9/25/1964	Michael	J	Coleman	38.5	2023 Farmington Lakes Drive		Weymouth	MA	01913
402-23-3294	11/2/2012	11/1/2012	6/30/2013	9/27/1967	Michael	Curtis	Conway	100	9174 Centerville Road		Gaithersburg	MD	20879
435-29-9670	2/1/2005	2/1/2005	4/25/2011	10/21/1969	Angela	S	Conway	64	184 Hayes Ln		Lexington	CV	40432
405-79-9221	9/1/2008	9/1/2008	12/31/2006	3/7/1952	Ann	Elaine	Crawford	741	601 Seaway Way		Lexington	CV	40503
405-79-9609	11/19/1990	12/1/2003	12/31/2006	6/27/1984	Whitney	Huffman	Crowe	576.1	191 The Masteri		Georgetown	CV	40324
401-31-4456	1/1/2015	1/1/2015	2/6/2015	6/27/1984	Whitney	A	Crowe	41	269 Meadow Valley Rd		Lexington	CV	40391
374-08-9720	1/5/2009	1/1/2009	6/10/2011	8/10/1967	Paul	E	Crowe	622.5	2009 White Conkright Road		Winchester	CV	40391
405-31-5780	4/17/2006	5/1/2006	6/10/2011	3/25/1980	Robert	Crazy	Crowe	452	102 Warren Pass		Georgetown	CV	40324
405-35-9916	12/17/2003	6/10/2011	9/10/2012	5/13/1973	Matthew	T	Degshan	150	Goodrich Ave		Lexington	CV	40503
403-31-0103	10/1/2009	9/10/2012	2/6/1985	Matthew	T		Degshan	143	265 West Beaver St		Belleville	PA	19313
							DeSharon		120 E Main Street		Lexington	CV	40507

401-41-2500	11/26/2007	12/1/2007	3/15/2015	8/6/1981	Kore	Temayne	Dioreilly	417.5	2092 Williamsonburg Rd	Lexington	40564
402-41-3003	4/18/2005	6/1/2006	5/18/1975	Xavier	Michael	Donnelly	Donnelly	323	1602 Athens Ct	Lexington	40545
406-04-3812	11/17/2008	11/1/2008	6/30/1975	Jared	Trev	Donning	Donning	51.5	749 Lori Ln	Lexington	40517
405-78-9638	8/28/1993	12/1/2003	6/20/1952	Charlotte	T	Dunaway	Dunaway	600.25	613 Beechir Ct	Lexington	40515
513-44-1806	9/2/1997	12/1/2003	8/2/1945	Karen	L	Dunkin	Dunkin	8	2230 N Dickcreek	Derby	40517
400-98-8119	03/01/05	12/1/2003	7/23/1961	Annmarie		Dupont-Fishing	Dupont-Fishing	46	3772 Blandford Dr	Lexington	40509
407-02-3101	6/1/2004	6/1/2004	5/17/1973	Cheryl		Tour	Tour	260	1415 Parkland Heights	Cynthiana	41031
407-31-4734	9/1/2004	9/1/2004	12/1/2003	Lee		Edmondson	Edmondson	8	952 Jefferson St	Lexington	40508
465-71-4616	7/20/2015	7/1/2015	12/4/1981	Colton	B	Elmgren	Elmgren	30	371 Ramson Trace	Georgetown	40334
402-13-3773	2/19/2008	3/1/2008	3/16/1978	Allison	B	Felley	Felley	43	1101 Beaumont Center Ln	Lexington	40513
402-76-2593	10/16/1987	12/1/2003	10/30/1980	Theodore	A	Fick	Fick	356.15	106 Lakeside Court	Georgetown	40834
406-25-4105	8/20/2007	9/1/2007	10/30/1980	Rebecca	A	Fink	Fink	134	1734 East 22nd St	Lexington	40511
320-29-4062	1/1/2014	1/1/2014	4/7/2015	Rebekah	J	Fitzgerald	Fitzgerald	145	528 Spring Hill Dr	Chapman	40503
404-84-9684	6/1/2005	6/1/2005	4/24/1988	Lynne		Flynn	Flynn	134	528 Spring Hill Dr	Lexington	40503
383-60-4567	12/9/2004	12/1/2003	10/26/1993	Barbara	S	Foster	Foster	109.8	5 Lindenwood Lane	Lexington	40505
195-52-9773	1/1/2002	12/1/2003	7/22/1954	Chad	S	Frank	Frank	156	12511 Dominion Way	Lexington	40299
407-70-7106	9/6/2006	3/1/2006	11/17/1973	Wanda		Kramer	Kramer	58.5	502 Hunters Ridge Drive	Lexington	40514
401-17-2180	12/9/2006	12/1/2006	3/26/1950	Wanda	M	Garcia Baker	Garcia Baker	36	113 McCalland Springs Drive	Georgetown	40334
401-45-6105	11/1/2013	11/1/2010	6/30/1969	Shawn		Gault	Gault	73.5	114 North Dixie Ave	Lexington	40504
039-50-7875	3/16/2011	3/1/2011	8/14/1976	Scott		Gilbert	Gilbert	254.5	993 Deer Crossing Way	Lexington	40209
404-31-9210	11/27/2000	7/1/2004	9/12/1977	Larry	Christopher	Ginn	Ginn	4	1109 S Park	Verlaine	40383
407-94-8585	11/1/2005	11/1/2005	9/17/1971	Jennifer	Matthew	Ginn	Ginn	42.5	224 Timberwood Dr	Georgetown	40334
402-70-2792	10/24/2003	10/1/2005	9/13/1951	Josephine	L	Gourgeth Jones	Gourgeth Jones	802.25	19 Flwy Road	Lexington	40601
406-78-4848	9/1/2005	9/1/2005	8/13/2013	Patricia	S	Graft	Graft	238	689 Kingston Road	Frankfort	40601
405-99-9421	4/16/2010	4/1/2010	12/6/1957	Emma	Chuk	Grady	Grady	280	238 South Hill Road	Verlaine	40361
403-13-8460	9/1/2005	9/1/2005	6/17/1964	Steven	D	Good	Good	310.25	5041 Wyndigo Dr	Lexington	40334
405-98-1346	8/29/1976	12/1/2003	7/15/1949	Howard	Michelle	Hager	Hager	800	176 Colony Drive	Lexington	40515
274-42-4172	9/1/2007	9/1/2007	4/25/1987	Arnold	M	Hagman	Hagman	905	1445 Francis Drive	Georgetown	40334
401-37-3674	10/1/2015	10/1/2015	10/2/1983	Whitney	Chuk	Hale	Hale	15	110 Olympia Way	Lexington	40517
407-31-5786	2/20/2006	2/2/2006	9/1/1982	Whitney	M	Halt	Halt	23	117 Piccadilly Ln	Georgetown	40334
480-13-7621	1/1/2000	12/1/2003	10/27/1968	Albert		Hartson J	Hartson J	216	1914 Nicholas Rd	Georgetown	40326
400-15-7673	6/30/2014	6/1/2014	9/1/1986	Nicole		Hartness	Hartness	18	222 Bolivar St	Lexington	40503
403-31-3802	7/2/2007	7/1/2007	10/2/1983	Enrica		Harvey	Harvey	12	3432 Kerne Road	Lexington	40508
401-46-9981	9/1/2013	9/1/2013	5/1/1963	Stephen		Hogan	Hogan	216	410 Kimberlin Ct	Lexington	40334
402-25-4335	6/20/2011	6/1/2011	3/26/1966	Paul	Patrick	Hogge	Hogge	216	2026 Silver Lake Blvd	Frankfort	40517
405-25-9460	5/16/2004	5/1/2004	10/4/1973	Joseph	N	Holc	Holc	16.5	2139 Saint Mathilda Drive	Lexington	40601
240-35-4676	5/18/2015	5/1/2015	5/9/2007	Kerry		Holc	Holc	50	304 Preston Ave	Lexington	40502
233-08-3419	10/29/2007	11/1/2007	10/23/1983	Shawn	M	Hopkins	Hopkins	52	139 Hawthorne Dr	Georgetown	40502
426-74-7617	7/7/2003	6/1/2004	3/1/1975	Jennifer	Hilary	Hopkins	Hopkins	310.5	405 Stenhalde Place	Lexington	40324
407-27-0354	8/5/2001	12/1/2003	3/6/1970	Laroyed	Cathleen	Hopkins	Hopkins	32	181 Chennault Road	Lexington	40517
405-19-1160	3/23/2005	3/1/2005	4/7/1982	Jessica	Tavia	Hughes	Hughes	188	4390 Chenault Way	Lexington	40503
406-68-5355	6/1/2004	6/1/2004	10/12/1986	Christopher	A	Hughes	Hughes	304.5	4856 Fairbrook Blvd	Richmond	40515
405-39-9391	5/1/1999	12/1/2003	3/15/2015	6/30/2013	Ilene	Hurst	Hurst	800	407 Village Dr	Lexington	40515
407-25-7240	2/10/2003	12/1/2003	5/13/1977	Julia	Michelle Morgan	Ilmari	Ilmari	713.5	43 West Cartriden	Lexington	40515
286-70-4320	3/15/2010	3/1/2010	5/12/1972	Chilline	Yvonne	Jacobus	Jacobus	89.5	457 Fodorough Court	Verlaine	40383
400-19-9186	8/20/2007	9/1/2007	4/22/1982	Steven		Jenkins	Jenkins	14	7101 Ething Pine Rd	Denton	40383
403-31-5769	7/16/2010	7/1/2010	2/20/1967	Tyler	W	Jennings	Jennings	8	626 112 W Barry Ave	Georgetown	7608
407-31-6070	4/1/2006	4/1/2006	12/29/1967	Carol		Jerry	Jerry	264	717 S Hamilton St	Georgetown	40324
178-44-3054	11/1/2004	11/1/2004	3/25/2011	Ann	Vernice	Kelly	Kelly	375.9	1035 Old Oxford Road	Lexington	40513
406-02-1239	4/16/1987	12/1/2003	11/22/1980	Volend		Kenneth	Kenneth	397.45	3301 Pastern Court	Lexington	40503
243-47-5452	8/1/2007	8/1/2007	5/16/1993	Thera	D	Kerran	Kerran	43	526 Springhill Drive	Lexington	40503
402-33-5456	11/1/2005	11/1/2005	5/26/1977	Molly		King	King	28	1302 Coburn Rd	Lexington	28352
407-06-0209	2/28/2005	2/1/2005	5/10/1960	Anthony	Eric	Lampert	Lampert	11	604 Paradise Drive	Lexington	40503
407-13-1435	6/15/1987	12/1/2003	7/1/1968	Shawn	M	Lanter	Lanter	36	116 Anna Jennings Way	Georgetown	40324

353-56-7669	1/1/2004	11/1/2015	6/30/2013	6/6/1985	Jonathan	(Tomlinson)	Lawrence	358	1715 Parkway Dr	Lexington	KY	40501
405-90-1195	1/1/2005	1/1/2015	8/15/2007	4/5/1980	David	D	Lebman	80	2508 Langston Lane	Lexington	KY	40511
405-80-4474	2/16/2007	3/1/2007	8/15/2007	6/22/1953	John	D	Lake	24	1124 Deer Haven Dr	Lexington	KY	40601
403-29-6955	12/15/2003	12/1/2003		5/13/1973	Hassan	S	Leeper	403	3928 Repertive Drive	Lexington	KY	40511
407-74-8340	7/12/1946	12/1/2003		1/1/1963	Abby	S	Lettell	709	4304 Redstart Place	Lexington	KY	40511
304-54-6834	11/15/2004	11/1/2004	6/26/2006	6/20/1964	Daniel	E	Loconti	120	726 Trenton Ave	Lexington	KY	40517
405-33-1597	12/10/2009	12/1/2009		1/8/1981	Matthew	E	Lorne	1875	3504 Linden Place	Lexington	KY	40517
155-35-1792	2/23/2004	2/1/2004	6/13/2007	7/19/1971	Tiffany	E	Luke	10	102 W Edgewood Dr	Lexington	KY	40517
555-37-4722	9/28/2009	9/28/2009		4/20/1975	Matha	I	Malone	16.5	2406 Fadden Wilkes Drive	Lexington	KY	40509
32-66-9461	3/9/1998	7/1/2004	4/30/2006	4/23/1951	Arwyn	I	Marshall	598	3740 Highway 350	Lexington	KY	40509
407-27-0672	11/23/2009	11/1/2009	3/9/2010	2/1/1984	Arlvin	L	Martinez	16	152 Church and Ave	Lexington	KY	40515
585-96-9597	8/1/2010	8/1/2010		11/27/1970	John	L	Martinez	432	3225 Buckhorn Drive	Lexington	KY	40503
554-87-4162	12/6/2009	12/1/2007		9/12/1983	Adam	L	Martinez	437	400 Steading Road	Lexington	KY	40503
401-94-2667	10/22/2007	10/1/2007		5/1/1958	MW	Karl	McGee	728	756 Edmund Orel Lane	Lexington	KY	40503
824-34-5406	10/19/2015	10/2/2015		12/17/1987	Lisa	Catharine	McGee	728	756 Edmund Orel Lane	Lexington	KY	40503
380-46-7721	7/10/2006	7/1/2015	4/15/2007	7/27/1947	Martha	Arlin	McKenney	72	301 Beech Way	Lexington	KY	40475
406-25-1354	4/1/2015	4/1/2015		4/1/1969	Lori	Ann	McKenney	54	237 Masterson Station Drive	Lexington	KY	40511
407-90-8801	8/1/2004	8/1/2004	11/18/2008	12/17/1958	Michelle	Arlin	McKenney	8	105 Sonoma Dr	Lexington	KY	40511
535-96-2887	11/29/2010	11/1/2010		3/27/1983	Margaret	Merri	McKenney	214	2100 Old Paris Road	Lexington	KY	40511
405-92-5566	2/25/2001	12/1/2003	6/15/2015	7/29/1960	Diana	U.	McKenney	159/75	104 Leathwood Lane	Lexington	KY	40511
11-62-6729	3/16/2007	4/1/2007		9/28/1953	Debra	S.	Milby	407.5	700 Sheep Pen Road	Lexington	KY	40511
401-39-8987	9/1/2011	9/1/2011		2/20/1985	Kristen	E	Milby	16	201 Mason Springs Dr	Lexington	KY	40511
400-86-2269	9/28/2005	9/28/2005		9/25/1955	Rebby	E	Milby	39	1026 Park Place Dr	Lexington	KY	40475
403-15-6486	8/16/2006	10/1/2006		6/6/1973	Jason	C	Morton	624.75	5408 W Edgewood Drive	Lexington	KY	40515
408-74-0305	10/14/2004	10/1/2004	12/12/2014	4/28/1957	Mary	Ann	Mosley	8	6813 W 83rd St Terrace	Lexington	KY	40515
405-06-0802	11/20/2008	11/1/2008		9/28/1975	Karen	Blackwell	Mosley	17	15 Sheffield Lane	Lexington	KY	40601
403-40-4301	6/1/2004	6/1/2004		10/20/1993	Nicholas	P	Mosley	75	3889 Thornhill Ln	Lexington	KY	40514
405-04-0043	2/1/2008	2/1/2008		6/13/1974	Madison	C	Mosley	377	1069 Ambushwood Court	Lexington	KY	40514
590-50-4118	11/1/2006	11/1/2006		9/1/1971	Douglas	M	Mosley	13.5	4035 Winthrop Way	Lexington	KY	40515
402-15-9316	4/23/2004	4/1/2004		6/29/1908	Andrea	F	O'Leary	129	641 Snider's Hatch	Lexington	KY	40509
408-15-5005	03/30/05	3/1/2005		7/5/1975	Shannon	B	O'Leary	14	425 Spring St	Lexington	KY	40508
400-33-9018	2/9/2004	2/1/2005		10/15/1975	Shelly	C	Osborn	16	485 Netten Rd	Lexington	KY	40508
401-02-0358	2/12/2009	2/1/2009		10/15/1966	Jennifer	C	Osborn	104	108 Chestnut Court	Lexington	KY	40537
402-19-9600	7/26/2004	7/1/2004	1/21/2006	11/4/1973	Shelia	H	Ferry	120	130 Barbary Lane	Lexington	KY	40603
403-31-3584	4/23/2005	4/1/2005		3/24/1971	Hance	Anthony	Wickatt	474.5	1570 Ellison Hill Rd	Lexington	KY	40504
405-68-5354	9/16/2002	12/1/2003	7/15/2004	2/20/1951	Charlotte	6/14/1911	Forrester	23	3539 Cave Hill Plac	Lexington	KY	40513
405-31-0412	3/18/2013	3/1/2013		6/14/1911	Chli		Phice	91	2216 Sage Rd	Lexington	KY	40514
313-94-0093	09/22/05	3/1/2005	9/23/2005	9/14/1984	Joseph		Trickett	185	1932 Greenleaf Drive	Lexington	KY	40506
401-15-3568	5/20/2005	9/1/2005		7/1/1990	Sacha	D.	Fratt	35	1073 Spring Run Rd	Lexington	KY	40514
733-20-4760	8/1/2007	8/1/2007		8/14/1964	Chrt		Byer	800	3389 Penick Plwy	Lexington	KY	40517
405-27-2092	8/1/2004	8/1/2006		3/13/1969	Richard	M	Razor	138.5	650 Repertive Way	Lexington	KY	40502
405-31-3056	4/1/2004	4/1/2004	2/15/2006	12/10/1980	Samuel	Doris	Rezer	107	1805 Versailles Rd	Lexington	KY	40502
400-27-5995	1/21/2015	2/1/2015	2/15/2015	8/7/1982	Sarah	Scott	Rezer	33	140 Carriage Lane	Lexington	KY	40504
400-13-7465	8/1/2007	12/1/2003	12/1/2005	4/18/1971	Karen	E	Rezer	80	1612 Capitol Way	Lexington	KY	40514
407-25-9866	10/22/1904	10/1/2004	9/13/2012	1/13/1905	Susan		Rezer	210	115 Forest Ave	Lexington	KY	40517
404-17-6995	10/26/2015	10/1/2015	9/10/2004	4/6/1977	Winta	A	Ridderl	8	1009 Blackcat Dr	Lexington	KY	40508
401-33-1467	8/9/2004	8/1/2004		1/20/1995	Elizabeth	Gaines	Ridderl	210	115 Forest Ave	Lexington	KY	40517
363-50-5781	5/1/2006	5/1/2006		8/23/1971	Jabecah	L.	Roehne	108	315 Stonegate Street	Lexington	KY	40514
455-29-1260	10/20/2009	10/1/2009	1/10/2010	6/17/1947	Michael	F.	Robison	16	3630 Elmgrass Dr	Lexington	KY	40502
405-31-5857	11/30/2015	11/1/2015	1/10/2016	20/1/1966	Robie		Robison	107	4037 Repertive Dr	Lexington	KY	40513
431-61-1043	1/1/2012	1/1/2012	3/7/2014	9/10/1973	Shawn	A	Ross	20	2172 Island Dr	Lexington	KY	40502
300-73-0770	02/16/05	2/1/2005	04/18/05	12/18/1978	Byrdon	B.	Satin	177.25	3416 Lando Dr	Lexington	KY	40517
406-57-3327	10/16/2007	11/1/2007	1/1/2014	3/1/1982	Bernie	Darastown	Saturday	148	245 Taylor Fork Road	Lexington	KY	40475
35-86-1595	8/16/2007	9/1/2007		2/11/1977	Kathrine	A	Scott	104	1410 Linwood Avenue	Lexington	KY	40475
101-04-7760	3/1/2004	10/15/2004	9/16/1965	9/16/1965	Ronald	H.	Scott	56	1104 Copperfield Lane	Lexington	KY	40334

407-34-4100	4/1/2006	4/1/2006	6/19/2006	6/1/1983	Stephen	Scott	18	307 Greenview	Lawrenceburg	KY	40342
405-84-3206	5/28/1985	12/1/2003		1/6/1960	Bradley	Jason	99.3	217 Atwood Dr	Georgetown	KY	40324
550-90-0901	9/11/2015	9/1/2013		8/13/1967	Elizabeth	Shaffer	20	1313 Nancy Hanki Road	Lexington	KY	40504
406-04-0714	6/16/1993	12/1/2003		9/28/1965	Tina	Shaw	800	2141 Redwell Dr	Lexington	KY	40513
407-74-9074	9/1/2006	9/1/2006		6/1/1967	James	Stone	519	3404 Oakbrook Drive	Lexington	KY	40515
405-05-7844	10/10/2005	10/1/2005			Sean	Slusher	42	2894 Jenna West	Lexington	KY	40502
060-54-6928	1/5/2004	1/1/2004	7/28/2006	10/22/1975	Eugene	M	85	3413 William Lane	Lexington	KY	40511
382-98-8939	10/13/2006	11/1/2006	05/1/05	8/20/1972	Freeman	Holmes	43	40 Romney Rd	Lexington	KY	40502
275-79-2876	13/12/2006	13/1/2006	5/11/2007	9/29/1991	Michelle	Smith	67	3413 William Lane	Lexington	KY	40504
402-76-3419	4/1/2007	4/1/2007	7/16/2007	9/25/1991	Sherron	R	0	720 Wesley Ridge Rd	Lexington	KY	40504
048-98-9689	10/17/1979	6/1/2004	11/10/2009	9/17/1955	Fayvel	Anthony	626	708 Lincoln Drive	Lexington	KY	40504
910-90-5208	10/18/2004	10/1/2004	12/31/2008	3/20/1960	Daniel	Mc	493	9641 Running Tree Lane	Lexington	KY	40509
400-45-3156	7/1/2011	7/1/2011	6/9/2014	3/6/1977	Nancy	Rose	24	103 Falcon Court	Georgetown	KY	40324
340-72-5730	5/1/2014	5/1/2014		6/26/1989	Kelley	Rene	108.5	109 Byron Street	Georgetown	KY	40324
317-06-1034	4/1/2014	4/1/2014		12/28/1976	Lindsey	M	44	108 Voss Dr	Georgetown	KY	40324
623-27-4315	1/1/2003	12/1/2003	30/8/2014	6/29/1981	Kent	A	72	161 Lattimore Rd	Georgetown	KY	40324
497-62-4038	6/1/1986	12/1/2003	9/30/2004	3/29/1941	Sundharan	John	765	2900 Crosby Dr	Georgetown	KY	40324
400-43-6072	5/12/2014	5/1/2014	5/31/2007	7/28/1947	Linda		7.2	2093 Williamburg Rd	Georgetown	KY	40324
404-66-5452	7/1/1993	12/1/2003	12/31/2008	11/18/1988	MacLundie		892.2	40 Spindrift St	Georgetown	KY	40324
406-06-8879	5/24/2004	5/1/2004	10/9/2005	12/26/1950	Pamela		763.25	437 Kingwood Drive	Georgetown	KY	40324
405-11-3123	6/12/2006	6/1/2015		3/20/1974	Amy		312	2041 Langford Dr	Georgetown	KY	40324
356-19-7805	10/21/1996	12/1/2003		4/24/1969	Kevin		50	1208 Fishery Creek Circle	Georgetown	KY	40324
271-82-7182	11/1/2006	11/1/2006		8/25/1969	George	Thomas	78	2121 Fort Harrods Drive	Georgetown	KY	40324
480-13-9122	9/16/2005	9/1/2005	7/18/2008	9/26/1981	Erica	Matthew	212	567 N Buffalo St	Georgetown	KY	40324
402-96-6514	6/16/2014	6/1/2014	10/15/2008	4/13/1980	Maggan	E	50	1101 Beaumont Centre Ln	Georgetown	KY	40324
400-35-0592	5/16/2007	6/1/2007		6/16/1960	Kathleen	Taylor	212	4113 Palomar Blvd	Georgetown	KY	40324
405-75-4755	6/21/1986	6/1/2004	6/15/2009	3/30/1977	Amy	K	545.5	591 Washington Ave	Georgetown	KY	40324
263-65-7123	3/7/2005	3/1/2005	4/15/2013	10/10/1956	William	K	4	106 Creekside Drive	Georgetown	KY	40324
233-94-1870	5/1/2010	5/1/2010	7/9/2010	9/13/1967	Robert	Kevin	304	121 Reak Court	Georgetown	KY	40324
401-04-1470	4/16/2007	5/1/2007	11/5/2013	8/14/1965	Donald	Thomas	16	1331 Seaden Park	Georgetown	KY	40324
400-04-5207	11/16/2004	11/1/2004	03/03/05	11/22/1968	Bradley	L	4	4225 Forsythe Drive	Georgetown	KY	40324
403-41-6210	12/1/2015	12/1/2015		8/20/1984	Elizabeth	D	4	355 South Broadway	Georgetown	KY	40324
405-04-6134	4/9/2007	4/1/2007	5/27/2009	8/24/1974	Darlene	Berna	73	265 Hwy Blvd	Georgetown	KY	40324
529-70-0750	10/26/2007	11/1/2007		4/1/1949	Rickie	Elvett	150	801 Lost Trail Cir	Georgetown	KY	40324
632-46-6785	9/26/2013	9/1/2013		9/19/1950	Morgan	Elvett	156	3612 North 2175 East	Georgetown	KY	40324
280-18-6314	3/16/2012	3/1/2012		5/1/1990	Lula	Elvett	95.7	PO Box 11141	Georgetown	KY	40324
800-72-6255	7/16/2012	7/1/2012		3/21/1978	Arleta	Ward	103.75	3104 Captiva Court	Georgetown	KY	40324
531-96-7435	8/4/2014	8/1/2014		4/25/1984	Clinton	Wood	104	110 Summeridge Rd	Georgetown	KY	40324
405-41-6403	8/18/2014	8/1/2014		2/15/1991	Chadwell	Young	76	221 Taylor Drive	Georgetown	KY	40324
								645 Stanford Drive	Georgetown	KY	40324

Attachment 10

CSG's most recent five (5) audited financial statements and independent auditor reports.



**THE COUNCIL OF
STATE GOVERNMENTS**

**FINANCIAL STATEMENTS AND
REPORT OF INDEPENDENT AUDITORS**

JUNE 30, 2015 AND 2014

THE COUNCIL OF STATE GOVERNMENTS

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REPORT OF INDEPENDENT AUDITORS

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of The Council of State Governments (a nonprofit organization, the Council), which comprise the statements of financial position as of June 30, 2015 and 2014, and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Council as of June 30, 2015 and 2014, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditures of federal awards, as required by *Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* is presented for purposes of additional analysis and is not a required part of the financial statements. The combining statements of financial position and activities, and the schedules of amounts due to and due from managed organizations are presented for purposes of additional analysis and are not a required part of the financial statements. The combining information on pages 17 through 20 is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual departments the Council. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 4, 2015 on our consideration of the Council's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Council's internal control over financial reporting and compliance.

Blue & Co., LLC

Lexington, Kentucky
December 4, 2015

THE COUNCIL OF STATE GOVERNMENTS

STATEMENTS OF FINANCIAL POSITION JUNE 30, 2015 AND 2014

	<u>2015</u>	<u>2014</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 8,651,025	\$ 8,916,158
Receivables:		
Grants and contracts	2,916,219	2,969,428
Publications, net of allowance for uncollectible accounts of \$20,000 for 2015 and 2014	78,794	89,169
Appropriations		79,246
Due from managed organizations	131	90,089
Prepaid expenses	666,357	174,638
Total current assets	<u>12,312,526</u>	<u>12,318,728</u>
Noncurrent assets:		
Investments	19,324,253	19,222,745
Property and equipment, net	626,666	662,054
Total noncurrent assets	<u>19,950,919</u>	<u>19,884,799</u>
Total assets	<u>\$ 32,263,445</u>	<u>\$ 32,203,527</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 1,534,153	\$ 1,396,925
Accrued salaries	765,929	752,858
Accrued compensated absences	1,636,119	1,564,322
Due to managed organizations	15,441,757	15,261,738
Deferred revenue	2,600,482	3,665,532
Other accrued expenses	313,991	485,774
Total current liabilities	<u>22,292,431</u>	<u>23,127,149</u>
Unrestricted net assets:		
Undesignated	8,994,348	8,014,324
Board designated, policy programming	250,000	300,000
Board designated, building fund	100,000	100,000
Investment in property and equipment, net	626,666	662,054
Total net assets	<u>9,971,014</u>	<u>9,076,378</u>
Total liabilities and net assets	<u>\$ 32,263,445</u>	<u>\$ 32,203,527</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

STATEMENTS OF ACTIVITIES YEARS ENDED JUNE 30, 2015 AND 2014

	<u>2015</u>	<u>2014</u>
Revenues:		
Grants and contracts	\$ 17,661,012	\$ 15,533,034
Appropriations and membership dues	6,630,006	6,640,952
Foundation and project revenue	4,967,503	4,296,419
Contributions	1,724,017	1,171,717
Corporate associates	1,473,500	1,149,000
Service recovery	1,177,563	1,195,296
Sales of publications	172,756	155,750
Interest and dividends	195,486	258,645
Conference center rental	0	75,677
Meeting and conference registrations	321,131	171,719
Net realized and unrealized gains on investments	45,459	193,520
Other	87,615	51,330
Donated facilities	447,015	402,000
Total revenues	<u>34,903,063</u>	<u>31,295,059</u>
Expenses:		
Salaries and wages	15,638,376	13,996,733
Employee benefits	4,625,809	3,971,008
Consultant and contract services	3,451,865	5,036,956
Travel and conferences	4,965,356	3,821,925
Rent and property maintenance	1,805,417	1,435,429
Office expenses	1,449,801	1,377,793
Printing and publications	397,302	300,030
Equipment maintenance	461,954	403,885
Depreciation	178,277	174,918
Contributions to managed organizations	587,255	543,721
In-kind donations, rent expense	447,015	402,000
Total expenses	<u>34,008,427</u>	<u>31,464,398</u>
Change in net assets	894,636	(169,339)
Net assets, beginning of year	<u>9,076,378</u>	<u>9,245,717</u>
Net assets, end of year	<u>\$ 9,971,014</u>	<u>\$ 9,076,378</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2015 AND 2014

	<u>2015</u>	<u>2014</u>
Cash flows from operating activities:		
Change in net assets	\$ 894,636	\$ (169,339)
Adjustments to reconcile change in net assets to net cash flows from operating activities:		
Depreciation	178,277	174,918
Realized and unrealized gains on investments	(45,459)	(193,520)
Changes in operating assets and liabilities:		
Accounts receivable - publications	10,375	111,072
Accounts receivable - grants and contracts	53,209	(610,760)
Accounts receivable - appropriations	79,246	46,754
Interest receivable	0	55,027
Prepaid expenses	(491,719)	34,454
Accounts payable	137,228	82,478
Accrued salaries	13,071	79,573
Accrued compensated absences	71,797	135,538
Deferred revenue	(1,065,050)	1,007,786
Other accrued expenses	(171,783)	99,535
Net cash flows from operating activities	<u>(336,172)</u>	<u>853,516</u>
Cash flows from investing activities:		
Proceeds from sales of investments	579,791	45,502,486
Purchases of investments	(635,840)	(45,777,945)
Change in due from managed organizations	89,958	11,089
Proceeds from sales of equipment	0	271
Purchases of property and equipment	(142,889)	(148,290)
Net cash flows from investing activities	<u>(108,980)</u>	<u>(412,389)</u>
Cash flows from financing activities:		
Change in due to managed organizations	<u>180,019</u>	<u>85,298</u>
Change in cash and cash equivalents	(265,133)	526,425
Cash and cash equivalents, beginning of year	<u>8,916,158</u>	<u>8,389,733</u>
Cash and cash equivalents, end of year	<u>\$ 8,651,025</u>	<u>\$ 8,916,158</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of The Council of State Governments (the Council) is presented to assist in understanding the Council's financial statements. The financial statements and notes are representations of the Council's management who are responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Description of Organization and Basis of Presentation:

The Council is an unincorporated non-profit, multi-branch organization that serves the states and U.S. territories for the purpose of championing excellence in state government. The Council conducts research on state programs and problems, maintains an information service available to state officials and legislators, issues a variety of publications, acts as a state-federal liaison, promotes regional and state-local cooperation, organizes informative forums and conferences, and provides management services and staff for managed organizations.

The financial statements of the Council have been prepared on the accrual method of accounting. Accordingly, revenues are recognized when they are earned and expenses are recognized when they are incurred.

Governmental grant awards are deemed to be earned and reported as grant revenues when the Council has incurred expenses in compliance with the specific restrictions of the applicable grants. Revenue earned for which grant funds have not been received are reported as grants and contracts receivable, while grant funds received but not yet earned are reported as deferred revenue.

Financial Statement Presentation:

The financial statements of the Council have been prepared following the recommendations of Accounting Standards Codification (ASC) 958-205 - *Nonprofit Organization Entities, Presentation of Financial Statements*. Under the provisions set forth therein, net assets, revenues, gains and losses are classified based on the existence or absence of donor-imposed restrictions as follows:

- Unrestricted net assets - Net assets that are not subject to donor-imposed stipulations, and used for various program expenses and general operating functions.
- Temporarily restricted net assets - Net assets subject to donor-imposed stipulations that can be fulfilled by actions of the Council pursuant to those stipulations or that expire by the passage of time.
- Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the Council.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Use of Estimates:

Management uses estimates and assumptions in preparing the financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and reported revenues and expenses. Actual results could differ from those estimates.

Cash and Cash Equivalents:

For purposes of the statements of cash flows, cash and cash equivalents include cash on hand, cash on deposit, and investments with original maturities of three months or less.

Accounts Receivable:

Accounts receivable includes sales of publications and other receivables. Accounts receivable for sales of publications are stated at unpaid balances less allowance for doubtful accounts. Management estimates an allowance for bad debts based on previous collection experience. Specific accounts are written off when internal collection procedures have ended. Receivables are considered past due based on contractual terms and are recorded at net invoice amounts.

Investments and Investment Income:

Investments are reported at fair value and bear interest at various rates depending on the market. Investments are adjusted to market value at reporting dates, and realized and unrealized gains and losses are recorded in the statements of activities.

Property and Equipment:

Property and equipment acquisitions are stated at cost. Depreciation is provided for using the straight-line method over the estimated useful lives of the respective assets, which range from 2 to 20 years. Assets acquired by headquarters and the Washington, DC office with unit costs in excess of \$2,000 are capitalized. Items with unit costs below this threshold shall be expensed in the year purchased. Assets acquired by regional offices with unit costs in excess of \$1,000 are capitalized. Items with unit costs below this threshold shall be expensed in the year purchased. The cost of repairs and maintenance is expensed as incurred.

Management Services:

The Council provides management services to certain other organizations including cash management and accounting services. Revenue from these arrangements is included in service recovery in the accompanying statements of activities. The accompanying statements of financial position included the balances due to or due from the Council.

Under the Council's cash management policies, organizations with amounts due to them are paid interest from investment income at a rate of 0.75% less than the average return earned by the Council on money market funds and long-term investments if the managed organization participates in the long-term investment pool.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Organizations with amounts due from them are charged at a rate of 0.75% more than the average return earned by the Council on short-term investments (with a floor of 0.20%). Net interest income allocated to these organizations in 2015 and 2014 was approximately \$41,600 and \$42,100, respectively.

Appropriations and Memberships:

The Council is a member-driven association of state elected officials. Appropriations are the dues paid by member states. Each state's dues are based on a flat rate plus a population factor. In addition, there are Canadian provinces that are regional members.

Foundation and Project Revenue:

Foundation and project revenue consists primarily of contracts and similar arrangements with private foundations for various programs and other objectives within the overall mission of the Council.

Corporate Associates:

The Council administers a program which allows representatives of the private sector to participate and offer their perspectives to public sector members. Corporate associates are eligible for appointment to the Council's standing and public policy committees. Corporate associates have the opportunity to interact with state policymakers through national and regional conferences, program and policy work and international exchanges.

Contributions:

Contributions, including unconditional promises to give, are recognized as revenues in the period received and are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and nature of any donor restrictions. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Restricted contributions whose restrictions are satisfied in the period the contributions are received are reported as unrestricted contributions. Restricted net assets are reclassified to unrestricted net assets upon satisfaction of the time or purpose restriction. The Council did not have any donor-restricted contributions during the years ended June 30, 2015 and 2014.

Contributions of assets other than cash are recorded at their estimated fair value.

Compensated Absences:

It is the Council's policy to permit employees to accumulate earned but unused personal leave and sick pay benefits. Personal leave is accrued when earned. Accrued personal leave totaling approximately \$1,605,000 and \$1,534,000, respectively, as of June 30, 2015 and 2014 is included in the accompanying statements of financial position.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Accrued sick leave totaling approximately \$31,100 and \$30,700 as of June 30, 2015 and 2014, respectively, relates to sick leave earned prior to June 30, 1995 and represents 20% of the unused sick leave at the current rate of pay. Sick leave earned July 1, 1995 and thereafter is not accrued by the Council.

Deferred Revenue:

Deferred revenue at June 30, 2015 and 2014 consists of appropriations, fees for future meetings, deferred lease amounts, and deferred grant income.

Subsequent Events:

The Council evaluates events occurring subsequent to the date of the financial statements in determining the accounting for and disclosure of transactions and events that affect the financial statements. Subsequent events have been evaluated through December 4, 2015, which is the date the financial statements were available to be issued.

2. INVESTMENTS

The composition of investments consisted of the following at June 30 (amounts rounded):

	<u>2015</u>	<u>2014</u>
Equity mutual funds:		
Large cap	\$ 710,000	\$ 821,000
Medium cap	101,000	93,000
Small cap	105,000	93,000
Fixed income mutual funds:		
U.S. Treasury and Agency	312,000	274,000
U.S. Corporate	219,000	214,000
Other	56,000	38,000
Money market funds	17,647,000	17,515,000
Certificates of deposit	174,000	175,000
	<u>\$ 19,324,000</u>	<u>\$ 19,223,000</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

3. PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows at June 30 (amounts rounded):

	<u>2015</u>	<u>2014</u>
Land	\$ 173,000	\$ 173,000
Buildings and improvements	439,000	439,000
Equipment	1,871,000	1,789,000
	<u>2,483,000</u>	<u>2,401,000</u>
Less accumulated depreciation	1,856,000	1,739,000
	<u>\$ 627,000</u>	<u>\$ 662,000</u>

4. RETIREMENT PLANS

The Kentucky employees of the Council who work more than 100 hours per month participate in a defined benefit plan administered by the Kentucky Employees Retirement Systems (KERS) of the Commonwealth of Kentucky, a multiple-employer public employee retirement system. Payroll for Council employees covered by KERS for the years ended June 30, 2015 and 2014 totaled approximately \$4,914,000 and \$5,000,000, respectively.

Covered employees hired before September 1, 2008 and before January 1, 2014, who retire at or after age 65, with 48 months of credited service, are entitled to an annual retirement benefit equal to 1.97% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's average of the five fiscal years during which the employee had the highest average monthly salary.

KERS participants have a fully vested interest after completion of 60 months of service, twelve months of which are current service. At a minimum, terminated employees are refunded their contributions with credited interest of 2.50% less contributions to the KERS Insurance Fund. Vested employees may retire after 27 years of service and receive full benefits or retire after age 55 or after 25 years of service and receive reduced retirement benefits. The KERS also provides death and disability benefits. Benefits are established by state statute.

Covered employees hired after September 1, 2008 and before January 1, 2014, who retire, at or after age 65 with a minimum of 60 months of credited service or when the employee's age plus their years of service credit equal 87 and they are at least 57 years of age, are entitled to an annual retirement benefit equal to 1.10% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's highest salaried five years. The employee may also be eligible for a reduced retirement benefit at 60 years of age and a minimum of 120 months of credited service. The KERS also provides death and disability benefits. Benefits are established by state statute.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Covered employees hired before September 1, 2008 are required by state statute to contribute 5.00% of their salaries to the plan. Covered employees hired after September 1, 2008 are required to contribute 5.00% of their salaries to the plan and 1.00% to the KERS Insurance Fund. The Council is required by the same statute to contribute 38.77% and 26.79% of the covered employee's salary for the years ended June 30, 2015 and 2014, respectively. Contributions for the years ended June 30, 2015 and 2014 were approximately \$1,905,000 and \$1,340,000, respectively. These amounts were equal to 100% of the required contributions for each year. The Council's required annual contributions represent less than five percent of total net contributions to the KERS plan.

Benefits under the KERS plan will vary based on final compensation, years of service, and other factors as fully described in the KERS plan documents.

The "pension benefit obligation" is a standardized disclosure measurement of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measurement, which is the actuarial present value of credited projected benefits, is intended to help users assess the pensions' funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among the plans and employers.

Senate Bill 2 was signed by the Governor on April 4, 2013. It contained a number of changes to the pension system that KERS implemented, effective January 1, 2014. The Bill created the hybrid cash balance plan for members who began participation on, or after, January 1, 2014. The Cash Balance Plan is known as a hybrid plan because it has characteristics of both a defined benefit plan and a defined contribution plan. The plan resembles a defined contribution plan because it determines the value of benefits for each participant based on individual accounts. However, the assets of the plan remain in a single investment pool like a traditional defined benefit plan. The plan is a defined benefit plan since it uses a specific formula to determine benefits.

All regular full-time employees who began participation with KERS on, or after, January 1, 2014 contribute to the hybrid cash balance plan. Participation in the plan is mandatory unless the employee is employed in a non-participating position. Employment classifications that are non-participating include part-time, seasonal, temporary, interim, emergency, and independent contractors.

Members and employers contribute a specified amount into the member's account. The account earns a guaranteed amount of interest at the end of each fiscal year. If the member has participated in the plan during the fiscal year, there may be an additional interest credit added to the member's account depending on KERS' investment returns. All interest is paid on the preceding year's balance.

When a member is eligible to retire, the benefit is calculated based on the member's accumulated account balance. A member earns service credit for each month they contribute to the plan. Once a member obtains 60 months of service credit, the member is considered vested. Vesting may change the level of benefits to which the member is entitled.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Members in the hybrid cash balance plan contribute a set percentage of their salary each month to their own account as required by Kentucky law:

- Nonhazardous members - 5% of creditable compensation
- Hazardous members - 8% of creditable compensation
- All members - 1% to the health insurance fund which is not credited to the member's account and is not refundable.

The employer contribution rate is based on an actuarial valuation. The employer contributes a set percentage of the member's salary. Each month, when employer contributions are received, an employer pay credit is deposited to the member's account. If the member is nonhazardous, the member's account is credited with a 4% employer pay credit. If the member is hazardous, the member's account is credited with a 7.5% employer pay credit. The employer pay credit represents a portion of the employer contribution.

In addition, Senate Bill 2 implemented provisions requiring employers to pay the actuarial cost of increases in an employee's salary in the last five years prior to retirement which result in increases the employee's pension, commonly known as pension spiking. All salary increases greater than 10% from one fiscal year to the next are presumed pension spikes. The law specifically excludes three situations from being considered pension spiking: 1. bona fide promotions; 2. career advancements; and 3. lump sum compensatory time paid at termination. For all members who retire on, or after, January 1, 2014, KERS will analyze the last five years of wages used in the retirement calculation to determine if a pension spike has occurred. If a pension spike has occurred, KERS will notify the last employer. Regardless of when the pension spike occurred, the last participating employer shall be required to pay for any additional actuarial costs resulting from annual increases in employee salary greater than ten percent (10%), which do qualify under one of three exceptions. If there were multiple last employers, the cost is divided equally amongst them. The employer is permitted a 12-month period to remit the amount due without interest.

Through its most recently issued comprehensive annual financial report, KERS has not made separate measurements of assets and pension benefit obligation for individual employers. The following table presents certain information regarding the plans' status as a whole, derived from actuarial valuations performed as of the dates indicated (amounts rounded):

Kentucky Employees Retirement System (Non-Hazardous Members)			
		June 30, 2014	June 30, 2013
Assets available for plan benefits, at fair value	\$	2,910,722,000	\$ 3,020,939,000
Pension benefit obligation		<u>(12,036,876,000)</u>	<u>(11,771,418,000)</u>
	\$	<u>(9,126,154,000)</u>	\$ <u>(8,750,479,000)</u>
Funded ratio on actuarial value of assets		24.18%	25.66%

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Ten-year historical trend information showing KERS's progress in accumulating assets to pay benefits when due is presented in its June 30, 2014 and June 30, 2013 comprehensive annual financial reports at <https://kyret.ky.gov/about/Publications/Pages/default.aspx>. The Council's contributions were less than 5% of total KERS contributions for fiscal year 2014.

As the Council is only one of several employers participating in the KERS program, it is not practicable to determine the Council's portion of the unfunded past service cost or the vested benefits of the Council's portion of the plan assets. The taxpayer ID number for KERS is 61-6027950.

In addition to the above defined benefit pension plan, a voluntary defined contribution plan is offered to all employees. Employees who participate may contribute either 2.00% or 5.00% of their salary into a tax-deferred annuity plan. Employees who elect to contribute 2.00% to shall receive a matching contribution by the Council of 4.00%. Employees who elect to contribute 5.00% shall receive a matching contribution by the Council of 10.00%. Employees who elect to participate in both KERS and the defined contribution plan will not receive a matching contribution from the Council to their defined contribution plan when the KERS mandated employer contribution meets or exceeds 10.00%.

Upon completion of 20 years of service, the Council will make an additional 10.00% contribution for no more than 5 years provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council reserves the right to extend this period for certain employees. The Council reserves the right to make additional Council plan contributions for the Executive Director provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council's contributions to the voluntary defined contribution plan amounted to approximately \$1,043,000 and \$947,000 in 2015 and 2014, respectively.

5. LEASE COMMITMENTS

The Council is obligated under various operating leases for offices and equipment rentals, which expire on various dates through 2028. Rent expense was approximately \$2,204,000 and \$1,867,000 in 2015 and 2014, respectively. Amounts for rent and property maintenance on the accompanying financials are net of recoveries from managed organizations.

Future gross minimum lease payments (assuming there are no managed organizations sharing in future rent expenses) as of June 30, 2015 are as follows (amounts rounded):

2016	\$	2,167,000
2017		2,110,000
2018		2,133,000
2019		2,064,000
2020		2,103,000
Thereafter		9,495,000
	\$	<u>20,072,000</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

Rental income associated with subleased office space was \$0 and approximately \$76,000, respectively, for the years ended June 30, 2015 and 2014.

6. GRANTS AND CONTRACTS

The Council has entered into agreements with various agencies of the United States Government and other organizations. The purpose of the agreements is to perform research and related projects, or assist in defraying expenses for projects undertaken by the Council. The grants and contracts are subject to various expenditure restrictions and are subject to examination by the granting agency to determine compliance with the related agreements.

Should any expenditure be disallowed, the Council would be required to refund disallowed amounts. For purposes of the accompanying financial statements, a provisional rate for indirect costs has been used as prescribed by the appropriate grantors. The proposal for final indirect cost rate for fiscal year 2015 is currently in process. As such, no provision for refund has been accrued in the accompanying financial statements.

Some grants contain provisions which require the Council and its grantees to contribute matching funds or in-kind services to the grant sponsored project. Matching funds and in-kind services were approximately \$3,000 and \$62,000 for the years ended June 30, 2015 and 2014, respectively.

7. FUNCTIONAL CLASSIFICATION

Following are expenses by functional classifications for the years ended June 30 (amounts rounded):

	2015	2014
Program expenses	\$ 31,760,000	\$ 29,398,000
Support expenses	1,998,000	1,900,000
Fundraising expenses	250,000	166,000
	<u>\$ 34,008,000</u>	<u>\$ 31,464,000</u>

8. CONCENTRATIONS

The Council maintained approximately \$9,360,000 and \$10,060,000 in an overnight repurchase agreement collateralized by governmental agency debt securities at June 30, 2015 and 2014, respectively. Money market funds, as discussed in Note 2, are maintained at various federally insured banks. The balance at each bank does not exceed the federally insured limit of \$250,000.

The Council maintains cash and certificate of deposit accounts with federally insured banks primarily in Lexington, Kentucky. At June 30, 2015 and 2014, approximately \$4,000 and \$175,000, respectively, was uninsured.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

For the years ended June 30, 2015 and 2014, approximately 51 and 50 percent, respectively, of all revenues were from federal grants.

9. INCOME TAXES

The Council is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (the Code). However, income from certain activities not directly related to the Council's tax-exempt purpose is subject to taxation as unrelated business income. In addition, the Council has been determined by the Internal Revenue Service not to be a private foundation within the context of Section 509(a) of the Code.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Council and recognize a tax liability if the Council has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the Council, and has concluded that as of June 30, 2015 and 2014, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements. The Council is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The Council has filed its federal income tax returns for periods through June 30, 2014. These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

10. FAIR VALUE MEASUREMENTS

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Council has the ability to access.
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2015 AND 2014

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at June 30, 2015 and 2014.

- **Mutual funds:** Valued at the daily closing price as reported by the fund. Mutual funds held by the Council are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Council are deemed to be actively traded.
- **Money market funds:** Generally transact subscription and redemption activity at a \$1 stable net asset value (NAV) however, on a daily basis the funds are valued at their daily NAV calculated using the amortized cost of the securities held in the fund.

The Council accounts for transfers between the levels within the fair value hierarchy at the end of the reporting period. There were no changes in the valuation methods used during 2015 or 2014, and there were no transfers between classes reported.

Following is a summary of assets measured at fair value on a recurring basis as of June 30 (amounts rounded):

2015

	<u>Level 1</u>	<u>Level 2</u>
Equity mutual funds	\$ 916,000	\$ 0
Fixed income mutual funds	587,000	0
Money market funds	0	17,647,000
	<u>\$ 1,503,000</u>	<u>\$ 17,647,000</u>

2014

	<u>Level 1</u>	<u>Level 2</u>
Equity mutual funds	\$ 1,007,000	\$ 0
Fixed income mutual funds	526,000	0
Money market funds	0	17,515,000
	<u>\$ 1,533,000</u>	<u>\$ 17,515,000</u>

Desegregated information regarding the above items is included in Note 2.

- SUPPLEMENTARY INFORMATION -

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF FINANCIAL POSITION

JUNE 30, 2015

	CSG	Grants	Eliminations	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 8,651,025	\$	\$	\$ 8,651,025
Receivables:				
Grants and contracts		2,916,219		2,916,219
Publications, net	78,794			78,794
Due from managed organizations	131			131
Due from CSG/Grants		(1,476,408)	1,476,408	0
Prepaid expenses	666,357			666,357
Total current assets	9,396,307	1,439,811	1,476,408	12,312,526
Noncurrent assets:				
Investments	19,324,253			19,324,253
Property and equipment, net	626,666			626,666
Total noncurrent assets	19,950,919	0	0	19,950,919
Total assets	\$ 29,347,226	\$ 1,439,811	\$ 1,476,408	\$ 32,263,445
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,534,153	\$	\$	\$ 1,534,153
Accrued salaries	765,929			765,929
Accrued vacation and sick pay	1,636,119			1,636,119
Due to CSG/Grants	(1,476,408)		1,476,408	0
Due to managed organizations	15,441,757			15,441,757
Deferred revenue	1,160,671	1,439,811		2,600,482
Other accrued expenses	313,991			313,991
Total current liabilities	19,376,212	1,439,811	1,476,408	22,292,431
Unrestricted net assets:				
Undesignated	8,994,348			8,994,348
Board designated, policy programming	250,000			250,000
Board designated, building fund	100,000			100,000
Investment in property and equipment, net	626,666			626,666
Total net assets	9,971,014	0	0	9,971,014
Total liabilities and net assets	\$ 29,347,226	\$ 1,439,811	\$ 1,476,408	\$ 32,263,445

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF FINANCIAL POSITION JUNE 30, 2014

	CSG	Grants	Eliminations	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 8,916,158	\$	\$	\$ 8,916,158
Receivables:				
Grants and contracts		2,969,428		2,969,428
Publications, net	89,169			89,169
Appropriations	79,246			79,246
Due from managed organizations	90,089			90,089
Due from CSG/Grants		(710,652)	710,652	0
Prepaid expenses	174,572	66		174,638
Total current assets	9,349,234	2,258,842	710,652	12,318,728
Noncurrent assets:				
Investments	19,222,745			19,222,745
Property and equipment, net	662,054			662,054
Total noncurrent assets	19,884,799	0	0	19,884,799
Total assets	\$ 29,234,033	\$ 2,258,842	\$ 710,652	\$ 32,203,527
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,396,925	\$	\$	\$ 1,396,925
Accrued salaries	752,858			752,858
Accrued vacation and sick pay	1,564,322			1,564,322
Due to CSG/Grants	(710,652)		710,652	0
Due to managed organizations	15,261,738			15,261,738
Deferred revenue	1,406,690	2,258,842		3,665,532
Other accrued expenses	485,774			485,774
Total current liabilities	20,157,655	2,258,842	710,652	23,127,149
Unrestricted net assets:				
Undesignated	8,014,324			8,014,324
Board designated, policy programming	300,000			300,000
Board designated, building fund	100,000			100,000
Investment in property and equipment, net	662,054			662,054
Total net assets	9,076,378	0	0	9,076,378
Total liabilities and net assets	\$ 29,234,033	\$ 2,258,842	\$ 710,652	\$ 32,203,527

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF ACTIVITIES YEAR ENDED JUNE 30, 2015

	CSG	Grants	Eliminations	Total
Revenues:				
Grants and contracts	\$	\$ 17,661,012	\$	\$ 17,661,012
Appropriations and membership dues	6,613,339	16,667		6,630,006
Foundation and project revenue		4,967,503		4,967,503
Contributions	1,127,808	596,209		1,724,017
Corporate associates	1,473,500			1,473,500
Service recovery	702,393		475,170	1,177,563
Sales of publications	172,756			172,756
Interest and dividends	195,486			195,486
Meeting and conference registrations	319,606	1,525		321,131
Net realized and unrealized gains on investments	45,459			45,459
Other	87,615			87,615
Grantee matching contributions		3,341	(3,341)	0
Donated facilities	447,015			447,015
Total revenues	<u>11,184,977</u>	<u>23,246,257</u>	<u>471,829</u>	<u>34,903,063</u>
Expenses:				
Salaries and wages	6,680,300	8,958,076		15,638,376
Employee benefits	2,493,916	2,131,893		4,625,809
Travel and conferences	1,614,295	3,351,061		4,965,356
Consultant and contract services	680,733	2,771,132		3,451,865
Office expenses	644,203	805,598		1,449,801
Rent and property maintenance	538,156	1,267,261		1,805,417
Contributions to managed organizations	587,255			587,255
Printing and publications	292,516	104,786		397,302
Equipment maintenance	385,854	76,100		461,954
Depreciation	178,277			178,277
In-kind donations, rent expense	447,015			447,015
	<u>14,542,520</u>	<u>19,465,907</u>	<u>0</u>	<u>34,008,427</u>
Grantee contributions		3,341	(3,341)	0
CSG contribution	(217,996)	217,996		0
Indirect costs recovered:				
Grants	(3,559,013)	3,559,013		0
Allocated	70,971		(70,971)	0
Managed organizations	(546,141)		546,141	0
Total expenses	<u>10,290,341</u>	<u>23,246,257</u>	<u>471,829</u>	<u>34,008,427</u>
Change in net assets	894,636	\$ <u>0</u>	\$ <u>0</u>	894,636
Net assets, beginning of year	<u>9,076,378</u>			<u>9,076,378</u>
Net assets, end of year	\$ <u><u>9,971,014</u></u>			\$ <u><u>9,971,014</u></u>

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF ACTIVITIES YEAR ENDED JUNE 30, 2014

	CSG	Grants	Eliminations	Total
Revenues:				
Grants and contracts	\$	\$ 15,533,034	\$	\$ 15,533,034
Appropriations and membership dues	6,624,285	16,667		6,640,952
Foundation and project revenue		4,296,419		4,296,419
Contributions	939,696	232,021		1,171,717
Corporate associates	1,149,000			1,149,000
Service recovery	609,730		585,566	1,195,296
Interest and dividends	258,645			258,645
Sales of publications	155,750			155,750
Meeting and conference registrations	159,319	12,400		171,719
Conference center rental	75,677			75,677
Net realized and unrealized gains on investments	193,520			193,520
Other	49,481	1,849		51,330
Grantee matching contributions		62,145	(62,145)	0
Donated facilities	402,000			402,000
Total revenues	<u>10,617,103</u>	<u>20,154,535</u>	<u>523,421</u>	<u>31,295,059</u>
Expenses:				
Salaries and wages	6,237,235	7,759,498		13,996,733
Employee benefits	2,144,905	1,826,103		3,971,008
Travel and conferences	1,413,480	2,408,445		3,821,925
Consultant and contract services	630,878	4,406,078		5,036,956
Office expenses	662,349	715,444		1,377,793
Rent and property maintenance	540,452	894,977		1,435,429
Contributions to managed organizations	543,721			543,721
Printing and publications	239,267	60,763		300,030
Equipment maintenance	330,665	73,220		403,885
Depreciation	174,918			174,918
In-kind donations, rent expense	402,000			402,000
	<u>13,319,870</u>	<u>18,144,528</u>	<u>0</u>	<u>31,464,398</u>
Grantee contributions		62,145	(62,145)	0
CSG contribution	(142,007)	142,007		0
Indirect costs recovered:				
Grants	(1,805,855)	1,805,855		0
Allocated	(49,076)		49,076	0
Managed organizations	(536,490)		536,490	0
Total expenses	<u>10,786,442</u>	<u>20,154,535</u>	<u>523,421</u>	<u>31,464,398</u>
Change in net assets	(169,339)	\$ 0	\$ 0	(169,339)
Net assets, beginning of year	<u>9,245,717</u>			<u>9,245,717</u>
Net assets, end of year	<u>\$ 9,076,378</u>			<u>\$ 9,076,378</u>

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF DUE FROM MANAGED ORGANIZATIONS

JUNE 30, 2015 AND 2014

	<u>2015</u>	<u>2014</u>
National Association of State Treasurers	\$ 131	\$ 0
National Association of State Treasurers - Restricted	0	1,568
National Association of State Treasurers Foundation, Inc.	<u>0</u>	<u>88,521</u>
Total due from managed organizations	\$ <u>131</u>	\$ <u>90,089</u>

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF DUE TO MANAGED ORGANIZATIONS JUNE 30, 2015 AND 2014

	2015	2014
21st Century Fund	\$ 193,315	\$ 153,665
American Probation and Parole Association	734,013	390,535
American Probation and Parole Association - Restricted Fund	13,056	24,229
American Probation and Parole Association - Services Account	96,832	86,554
Association of Air Pollution Control	189,003	5,540
Bowhay Institute of Legislative Leadership Development	241,648	244,672
Council of State Governments - West	225,601	116,348
Council of State Governments West Meetings	203,041	114,909
Eastern Regional Conference	293,351	152,933
Eastern Trade Council	323,807	237,767
Emergency Management Accreditation Program	919,966	850,034
Interstate Commission for Juveniles	1,335,907	1,458,981
Interstate Commission on Adult Offender Supervision	1,463,456	1,768,232
Interstate Commission on Educational Opportunity for Military Children	968,862	924,273
Midwest Legislative Conference	583,618	831,479
Midwest Passenger Rail Commission	257,233	210,675
Minds Against Crime	36,594	18,019
National Association of State Facilities Admin. - Eastern Region	3,088	3,223
National Association of State Facilities Admin. - Great Plains	2,885	6,007
National Association of State Facilities Admin. - Southeast Region	5,675	6,833
National Association of State Facilities Admin. - Western Region	6,420	3,635
National Association of State Facilities Administrators	396,965	415,954
National Association of State Personnel Executives, Inc.	441,118	403,179
National Association of State Technology Directors	706,557	640,884
National Association of State Technology Directors - Eastern Region	169,635	134,758
National Association of State Technology Directors - Midwest Region	93,411	60,711
National Association of State Technology Directors - Southern Region	186,135	106,544
National Association of State Technology Directors - Western Region	135,525	116,339
National Association of State Treasurers	0	888,769
National Association of State Treasurers - College Savings Plan	0	350,579
National Association of State Treasurers - State Debt Management Network	0	83,019
National Emergency Management Association	1,126,818	654,328
National Hispanic Caucus of State Legislators	1,776,611	1,547,182
National Hispanic Caucus of State Legislators - Restricted Fund	470,428	517,148
Northeast States Association for Agriculture Stewardship	119,384	64,133
Southern Legislative Conference	559,232	589,703
Southern Legislative Conference - Host State Accounts	372,846	362,924
State International Development Organization	229,446	244,848
Western Designated Fund	490,000	370,000
Western Legislative Academy	70,275	102,193
Total due to managed organizations	\$ 15,441,757	\$ 15,261,738

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2015

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
<u>Major Programs:</u>				
U.S. Department of Justice	145-161-70-11818	16.745	\$ 2,071,444	\$ 596,358
Supporting Effective Responses	145-161-70-11819	16.745	2,098,208	748,001
State Based Capacity Building	150-085-70-11455	16.751	500,000	34,988
Discovering Corrections Website Project	150-085-70-11587	16.751	1,000,000	104,850
Correction Information Sharing	150-161-70-11598	16.751	7,968,189	2,006,108
Justice Reinvestment Technology Assistance for States	150-161-70-11599	16.751	1,298,821	158,037
Mental Health Curriculum				
Bringing Network for the Improvement of				
Addiction Treatment to Corrections	150-161-70-11716	16.751	348,691	76,404
Law and Mental Health Data Collection	150-161-70-11596	16.751	428,122	12,932
Justice Reinvestment Initiative Intensive Tech Assistance	150-161-70-11912	16.751	15,113,727	2,564,951
National Re-entry Resource Center	145-161-70-11820	16.812	15,156,281	6,158,218
			<u>45,983,481</u>	<u>12,460,847</u>
U.S. Department of Defense				
Federal Voting Assistance Program	150-050-70-11928	H98210-13-2-0002	3,240,117	718,187
Total major programs			<u>49,223,598</u>	<u>13,179,034</u>
<u>Nonmajor programs:</u>				
U.S. Agency for International Development				
US/Mexico State Alliance Partnership	150-070-70-10552	523-A-00-08-00010-00	17,900,000	682,382

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2015

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
<u>U.S. Department of Energy</u>				
Radioactive Waste Transportation Project	11792	81,106	906,845	153,567
Radioactive Waste Transportation Project	11850	81,106	263,325	48,730
Radioactive Waste Transportation Project	11856	81,106	110,875	40,584
Energy Efficiency and Renewable Energy Information Dissemination, Outreach, Training and Technical Analysis (1)	11961	81,117	60,000	25,897
Radioactive Waste Transportation Project	11793	81,122	825,000	175,527
Radioactive Waste Transportation Project	11794	81,122	775,000	160,886
Integrating State and Federal Energy with Emergency Responses	12080	81,122	600,000	2,850
			<u>3,541,045</u>	<u>608,041</u>
<u>U.S. Department of Health and Human Services</u>				
Joint Policy Group	415-090-70-11923	93,069	90,256	45,462
Joint Policy Group	415-090-70-12002	93,069	68,875	59,875
National Institute of Health - Juvenile Justice Trials (2)	145-161-70-12009	93,279	12,000	12,000
Healthy Safe Children	145-161-70-12012	03522-1U79SM06151601	31,916	3,380
			<u>203,047</u>	<u>120,717</u>
<u>U.S. Department of Homeland Security</u>				
Urban Search & Rescue	330-146-70-11937	HSFE20-13-P-0285	200,000	73,315
Emergency Management Baseline Assessments Grant - 2012	330-146-70-11833	97,131	599,259	369,151
Emergency Management Baseline Assessments Grant - 2015	330-146-70-12025	97,131	900,000	475,947
			<u>1,699,259</u>	<u>918,413</u>

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2015

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
U.S. Department of Justice				
Supervision of Partner Abuse	150-085-70-10630	16.008	781,894	37,441
Offender is a Victim - Office on Violence Against Women	150-085-70-11825	16.526	225,000	48,602
Effective School Policies and Practices	150-161-70-11718	16.541	840,000	37,176
Information Sharing and the Role of the Sex Offender	150-085-70-12062	16.560	8,113	1,151
Tribal Correctional Options	150-085-70-11465	16.580	400,000	47,698
State-based Capacity Building	150-161-70-11595	16.580	1,562,468	72,893
Supporting Effective Responses	150-161-70-11597	16.580	1,516,405	(104)
Tribal Probation Training	150-085-70-11605	16.580	300,000	52,450
Tribal Probation Academy (3)	150-085-70-11648	16.580	44,829	531
National Re-entry Resource Center	150-161-70-11608	16.580	12,388,562	1,225,171
Project Safe Neighborhoods -				
Technology Technical Assistance Program	150-085-70-11717	16.580	200,000	37,224
Tribal Probation Academy - III (3)	150-085-70-11869	16.580	30,000	25,287
Training Curriculum Development - 2012	150-085-70-11821	16.601	90,264	3,916
Training Curriculum Development - 2014	150-085-70-12018	16.601	100,000	31,231
Intermediate Training on Effective Case Management	150-085-70-11463	16.608	417,802	45,283
Tribal Court	150-085-70-11816	16.608	876,511	161,292
Community Strategic Planning (3)	150-085-70-11859	16.608	60,206	15,015
Indian Alcohol and Substance Abuse (3)	150-085-70-11647	16.616	44,829	3,502
Resource Center for the Elimination of Prison Rape (4)	150-085-70-11813	16.735	104,230	4,157
Community Corrections Problem Solving	150-085-70-11435	16.738	669,677	88,776
Tribal Civil and Criminal Assistance	150-085-70-11815	16.815	698,559	81,504
			<u>21,359,349</u>	<u>2,020,136</u>

See report of independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2015

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
U.S. Department of Transportation				
Impaired Driving Tools	150-085-70-12020	20.614	149,906	36,417
National Highway Traffic Safety Administration Probation Fellow	150-085-70-11429	20.614	523,906	95,872
			<u>673,812</u>	<u>132,289</u>
Total nonmajor programs			<u>45,376,512</u>	<u>4,481,978</u>
Total all programs			<u>\$ 94,600,110</u>	<u>\$ 17,661,012</u>

- (1) - Passed through from Mid-America Regional Council.
 (2) - Passed through from Texas Christian University.
 (3) - Passed through from Fox Valley Technical College.
 (4) - Passed through from National Center for Crime and Delinquency.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2015

1. GENERAL

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the Council of State Governments (the Council). The Council's reporting entity is defined in Note 1 to the Council's financial statements. All federal financial assistance was received directly from federal agencies unless specifically noted on the schedule.

The grant revenue amounts received and expensed are subject to audit and adjustment. If any expenditures are disallowed by the grantor as a result of such an audit, any claim for reimbursement to the grantor would become a liability of the Council. In the opinion of management, all grant expenditures are in compliance with the terms of the grant agreements and applicable federal laws and regulations.

2. BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Council and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some of the amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2015

3. SUBRECIPIENTS

Of the federal expenditures presented in the schedule, the Council provided federal awards to subrecipients as follows (amounts rounded):

Subrecipient	CFDA Number or Other Identifying Number	Amount
Urban Institute	16.580	120,000
National Governors Association	16.580	16,000
Fox Valley Technical College	16.608	15,000
Kansas Department of Corrections	16.751	174,000
Hawaii Department of Public Safety	16.751	128,000
Pennsylvania Board of Probation	16.751	107,000
West Virginia Department of Military	16.751	50,000
University of Wisconsin - Madison	16.751	12,000
Urban Institute	16.812	101,000
National Association of Counties	16.812	101,000
Legal Action Center	16.812	66,000
Michigan State University	16.812	35,000
Council of Juvenile Correctional Administrators	16.812	27,000
University of Cincinnati	16.812	12,000
National Judicial College	16.815	26,000
University of North Dakota	16.815	16,000
Iowa Department of Public Health	81.106	59,000
Illinois Department of Emergency Management	81.106	25,000
Indiana Department of Homeland Security	81.122	25,000
Woodrow Wilson International Center for Scholars	523-A-00-08-00010	148,000
United States - Mexico Border Philanthropy Partnership	523-A-00-08-00010	22,000
North American Research	523-A-00-08-00010	21,000
National Association of State Treasurers	523-A-00-08-00010	13,000
Other	Various	43,000
Total federal awards passed through to subrecipients		\$ 1,362,000



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**REPORT OF INDEPENDENT AUDITORS ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT
AUDITING STANDARDS**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of The Council of State Governments (a nonprofit organization, the Council) which comprise the statement of financial position as of June 30, 2015, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated December 4, 2015.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Council's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Council's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Council's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Council's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Blue & Co., LLC

Lexington, Kentucky
December 4, 2015



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**REPORT OF INDEPENDENT AUDITORS ON COMPLIANCE FOR EACH
MAJOR FEDERAL PROGRAM AND ON INTERNAL CONTROL
OVER COMPLIANCE REQUIRED BY OMB CIRCULAR A-133**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Report on Compliance for Each Major Federal Program

We have audited The Council of State Governments (a nonprofit organization, the Council) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Council's major federal programs for the year ended June 30, 2015. The Council's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of the Council's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Council's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of the Council's compliance.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Opinion on Each Major Federal Program

In our opinion, the Council complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2015.

Report on Internal Control Over Compliance

Management of the Council is responsible for establishing and maintaining effective internal control over compliance with the types of requirements referred to above. In planning and performing our audit of compliance, we considered the Council's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Blue & Co., LLC

Lexington, Kentucky
December 4, 2015

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS YEAR ENDED JUNE 30, 2015

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unmodified

Internal Control over financial reporting:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Noncompliance material to financial
statements noted?

_____ yes X no

Federal Awards

Internal control over major programs:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Type of auditor's report issued on compliance for major programs: unmodified

Any audit findings disclosed that are
required to be reported in accordance
with section 510(a) of Circular A - 133?

_____ yes X no

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS YEAR ENDED JUNE 30, 2015

The Council's major federal programs for the year ended June 30, 2015 were:

CFDA No. 16.745:

Criminal and Juvenile Justice and Mental Health Collaboration Program

CFDA No. 16.751:

Edward Byrne Memorial Competitive Grant Program - See individual grant descriptions on Schedule of Expenditures of Federal Awards.

CFDA No. 16.812:

Second Chance Act Prisoner Reentry Initiative - National Re-entry Resource Center

CFDA No. 99.H98210-13-2-0002:

Federal Voting Assistance Program

The dollar threshold used to distinguish between Type A and Type B programs was \$529,830.

The Council qualified as a low-risk auditee under the provisions of OMB Circular A-133.

Section II - Findings - Financial Statement Audit

None reported.

Section III - Findings and Questioned Costs - Major Federal Awards Program Audit

None reported.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF PRIOR YEAR FINDINGS AND THEIR RESOLUTIONS YEAR ENDED JUNE 30, 2014

No findings or questioned costs were reported for the year ended June 30, 2014.



THE COUNCIL OF STATE GOVERNMENTS

**FINANCIAL STATEMENTS AND
REPORT OF INDEPENDENT AUDITORS**

JUNE 30, 2014 AND 2013

THE COUNCIL OF STATE GOVERNMENTS

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REPORT OF INDEPENDENT AUDITORS

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of The Council of State Governments (a nonprofit organization, the Council), which comprise the statements of financial position as of June 30, 2014 and 2013, and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Council as of June 30, 2014 and 2013, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditures of federal awards, as required by *Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* is presented for purposes of additional analysis and is not a required part of the financial statements. The combining statements of financial position and activities, and the schedules of amounts due to and due from managed organizations are presented for purposes of additional analysis and are not a required part of the financial statements. The combining information on pages 16 through 19 is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual departments the Council. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated December 10, 2014 on our consideration of the Council's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Council's internal control over financial reporting and compliance.

Blue & Co., LLC

Lexington, Kentucky
December 10, 2014

THE COUNCIL OF STATE GOVERNMENTS

STATEMENTS OF FINANCIAL POSITION JUNE 30, 2014 AND 2013

	<u>2014</u>	<u>2013</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 8,916,158	\$ 8,389,733
Receivables:		
Grants and contracts	2,969,428	2,358,668
Publications, net of allowance for uncollectible accounts of \$20,000 for 2014 and 2013	89,169	200,241
Appropriations	79,246	126,000
Interest receivable	0	55,027
Due from managed organizations	90,089	101,178
Prepaid expenses	<u>174,638</u>	<u>209,092</u>
Total current assets	<u>12,318,728</u>	<u>11,439,939</u>
Noncurrent assets:		
Investments	19,222,745	18,753,766
Property and equipment, net	<u>662,054</u>	<u>688,953</u>
Total noncurrent assets	<u>19,884,799</u>	<u>19,442,719</u>
Total assets	<u>\$ 32,203,527</u>	<u>\$ 30,882,658</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 1,396,925	\$ 1,314,447
Accrued salaries	752,858	673,285
Accrued compensated absences	1,564,322	1,428,784
Due to managed organizations	15,261,738	15,176,440
Deferred revenue	3,665,532	2,657,746
Other accrued expenses	<u>485,774</u>	<u>386,239</u>
Total current liabilities	<u>23,127,149</u>	<u>21,636,941</u>
Unrestricted net assets:		
Undesignated	8,014,324	8,256,764
Board designated, policy programming	300,000	300,000
Board designated, building fund	100,000	0
Investment in property and equipment, net	<u>662,054</u>	<u>688,953</u>
Total net assets	<u>9,076,378</u>	<u>9,245,717</u>
Total liabilities and net assets	<u>\$ 32,203,527</u>	<u>\$ 30,882,658</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

STATEMENTS OF ACTIVITIES YEARS ENDED JUNE 30, 2014 AND 2013

	<u>2014</u>	<u>2013</u>
Revenues:		
Grants and contracts	\$ 15,533,034	\$ 15,809,776
Appropriations and membership dues	6,640,952	6,755,124
Foundation and project revenue	4,296,420	5,457,025
Contributions	1,171,716	1,002,805
Corporate associates	1,149,000	817,000
Service recovery	1,195,296	696,285
Sales of publications	155,750	294,732
Interest and dividends	258,645	288,308
Conference center rental	75,677	165,093
Meeting and conference registrations	171,719	163,340
Net realized and unrealized gains on investments	193,520	115,374
Other	51,330	22,642
Donated facilities	402,000	280,000
Total revenues	<u>31,295,059</u>	<u>31,867,504</u>
Expenses:		
Salaries and wages	13,996,733	13,487,612
Employee benefits	3,971,008	3,859,983
Consultant and contract services	5,036,956	4,684,175
Travel and conferences	3,821,925	4,258,274
Rent and property maintenance	1,435,429	1,464,833
Office expenses	1,377,793	1,394,258
Printing and publications	300,030	371,062
Equipment maintenance	403,885	325,878
Depreciation	174,918	198,036
Contributions to managed organizations	543,721	188,188
In-kind donations, rent expense	402,000	280,000
Total expenses	<u>31,464,398</u>	<u>30,512,299</u>
Change in net assets	(169,339)	1,355,205
Net assets, beginning of year	<u>9,245,717</u>	<u>7,890,512</u>
Net assets, end of year	<u>\$ 9,076,378</u>	<u>\$ 9,245,717</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

STATEMENTS OF CASH FLOWS YEARS ENDED JUNE 30, 2014 AND 2013

	<u>2014</u>	<u>2013</u>
Cash flows from operating activities:		
Change in net assets	\$ (169,339)	\$ 1,355,205
Adjustments to reconcile change in net assets to net cash flows from operating activities:		
Depreciation	174,918	198,036
Realized and unrealized gains on investments	(193,520)	(115,374)
Changes in operating assets and liabilities:		
Accounts receivable - publications	111,072	(20,734)
Accounts receivable - grants and contracts	(610,760)	829,785
Accounts receivable - appropriations	46,754	161,856
Interest receivable	55,027	(2,999)
Prepaid expenses	34,454	38,822
Accounts payable	82,478	(15,039)
Accrued salaries	79,573	(33,656)
Accrued compensated absences	135,538	176,390
Deferred revenue	1,007,786	204,594
Other accrued expenses	99,535	(185,128)
Net cash flows from operating activities	<u>853,516</u>	<u>2,591,758</u>
Cash flows from investing activities:		
Proceeds from sales of investments	45,502,486	25,649,923
Purchases of investments	(45,777,945)	(25,862,299)
Change in due from managed organizations	11,089	15,750
Proceeds from sales of equipment	271	14,000
Purchases of property and equipment	(148,290)	(129,712)
Net cash flows from investing activities	<u>(412,389)</u>	<u>(312,338)</u>
Cash flows from financing activities:		
Change in due to managed organizations	<u>85,298</u>	<u>(212,247)</u>
Change in cash and cash equivalents	526,425	2,067,173
Cash and cash equivalents, beginning of year	<u>8,389,733</u>	<u>6,322,560</u>
Cash and cash equivalents, end of year	<u>\$ 8,916,158</u>	<u>\$ 8,389,733</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of The Council of State Governments (the Council) is presented to assist in understanding the Council's financial statements. The financial statements and notes are representations of the Council's management who are responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Description of Organization and Basis of Presentation:

The Council is an unincorporated non-profit, multi-branch organization that serves the states and U.S. territories for the purpose of championing excellence in state government. The Council conducts research on state programs and problems, maintains an information service available to state officials and legislators, issues a variety of publications, acts as a state-federal liaison, promotes regional and state-local cooperation, organizes informative forums and conferences, and provides management services and staff for managed organizations.

The financial statements of the Council have been prepared on the accrual method of accounting. Accordingly, revenues are recognized when they are earned and expenses are recognized when they are incurred.

Governmental grant awards are deemed to be earned and reported as grant revenues when the Council has incurred expenses in compliance with the specific restrictions of the applicable grants. Revenue earned for which grant funds have not been received are reported as grants and contracts receivable, while grant funds received but not yet earned are reported as deferred revenue.

Financial Statement Presentation:

The financial statements of the Council have been prepared following the recommendations of Accounting Standards Codification (ASC) 958-205 - *Nonprofit Organization Entities, Presentation of Financial Statements*. Under the provisions set forth therein, net assets, revenues, gains and losses are classified based on the existence or absence of donor-imposed restrictions as follows:

- Unrestricted net assets - Net assets that are not subject to donor-imposed stipulations, and used for various program expenses and general operating functions.
- Temporarily restricted net assets - Net assets subject to donor-imposed stipulations that can be fulfilled by actions of the Council pursuant to those stipulations or that expire by the passage of time.
- Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the Council.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

Use of Estimates:

Management uses estimates and assumptions in preparing the financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and reported revenues and expenses. Actual results could differ from those estimates.

Cash and Cash Equivalents:

For purposes of the statements of cash flows, cash and cash equivalents include cash on hand, cash on deposit, and investments with original maturities of three months or less.

Accounts Receivable:

Accounts receivable includes sales of publications and other receivables. Accounts receivable for sales of publications are stated at unpaid balances less allowance for doubtful accounts. Management estimates an allowance for bad debts based on previous collection experience. Specific accounts are written off when internal collection procedures have ended. Receivables are considered past due based on contractual terms and are recorded at net invoice amounts.

Investments and Investment Income:

Investments are reported at fair value and bear interest at various rates depending on the market. Investments are adjusted to market value at reporting dates, and realized and unrealized gains and losses are recorded in the statements of activities.

Property and Equipment:

Property and equipment acquisitions are stated at cost. Depreciation is provided for using the straight-line method over the estimated useful lives of the respective assets, which range from 2 to 20 years. Assets acquired by headquarters and the Washington, DC office with unit costs in excess of \$2,000 are capitalized. Items with unit costs below this threshold shall be expensed in the year purchased. Assets acquired by regional offices with unit costs in excess of \$1,000 are capitalized. Items with unit costs below this threshold shall be expensed in the year purchased. The cost of repairs and maintenance is expensed as incurred.

Management Services:

The Council provides management services to certain other organizations including cash management and accounting services. Revenue from these arrangements is included in service recovery in the accompanying statements of activities. The accompanying statements of financial position included the balances due to or due from the Council.

Under the Council's cash management policies, organizations with amounts due to them are paid interest from investment income at a rate of 0.75% less than the average return earned by the Council on money market funds and long-term investments if the managed organization participates in the long-term investment pool.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

JUNE 30, 2014 AND 2013

Organizations with amounts due from them are charged at a rate of 0.75% more than the average return earned by the Council on short-term investments. Net interest income allocated to these organizations in 2014 and 2013 was approximately \$76,000 and \$137,000, respectively.

Appropriations and Memberships:

The Council is a member-driven association of state elected officials. Appropriations are the dues paid by member states. Each state's dues are based on a flat rate plus a population factor. In addition, there are Canadian provinces that are regional members.

Foundation and Project Revenue:

Foundation and project revenue consists primarily of contracts and similar arrangements with private foundations for various programs and other objectives within the overall mission of the Council.

Corporate Associates:

The Council administers a program which allows representatives of the private sector to participate and offer their perspectives to public sector members. Corporate associates are eligible for appointment to the Council's standing and public policy committees. Corporate associates have the opportunity to interact with state policymakers through national and regional conferences, program and policy work and international exchanges.

Contributions:

Contributions, including unconditional promises to give, are recognized as revenues in the period received and are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and nature of any donor restrictions. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value. Restricted contributions whose restrictions are satisfied in the period the contributions are received are reported as unrestricted contributions. Restricted net assets are reclassified to unrestricted net assets upon satisfaction of the time or purpose restriction. The Council did not have any donor-restricted contributions during the years ended June 30, 2014 and 2013.

Contributions of assets other than cash are recorded at their estimated fair value.

Compensated Absences:

It is the Council's policy to permit employees to accumulate earned but unused personal leave and sick pay benefits. Personal leave is accrued when earned. Accrued personal leave totaling approximately \$1,534,000 and \$1,400,000, respectively, as of June 30, 2014 and 2013 is included in the accompanying statements of financial position.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

Accrued sick leave totaling approximately \$30,000 and \$29,000 as of June 30, 2014 and 2013, respectively, relates to sick leave earned prior to June 30, 1995 and represents 20% of the unused sick leave at the current rate of pay. Sick leave earned July 1, 1995 and thereafter is not accrued by the Council.

Deferred Revenue:

Deferred revenue at June 30, 2014 and 2013 consists of appropriations, fees for future meetings, deferred lease amounts, and deferred grant income.

Reclassifications:

Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform to the presentation in the current year. Amounts for donated facilities and in-kind rent expense were netted in the prior year financial statements. These are shown at gross in the current year. This change in presentation has no effect on assets, liabilities, net assets, or change in net assets for the prior year.

Subsequent Events:

The Council evaluates events occurring subsequent to the date of the financial statements in determining the accounting for and disclosure of transactions and events that affect the financial statements. Subsequent events have been evaluated through December 10, 2014, which is the date the financial statements were available to be issued.

2. INVESTMENTS

The composition of investments consisted of the following at June 30:

	<u>2014</u>	<u>2013</u>
Equity mutual funds:		
Large cap	\$ 821,501	\$ 662,110
Medium cap	92,624	98,378
Small cap	92,624	43,735
Fixed income mutual funds:		
U.S. Treasury and Agency	274,189	263,599
U.S. Corporate	213,668	211,567
Other	38,418	25,230
Money market funds	17,515,178	0
Certificates of deposit	174,543	17,449,147
	<u>\$ 19,222,745</u>	<u>\$ 18,753,766</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

3. PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows at June 30:

	2014	2013
Land	\$ 173,337	\$ 173,337
Buildings and improvements	438,802	504,991
Equipment	1,789,005	1,641,257
	2,401,144	2,319,585
Less accumulated depreciation	1,739,090	1,630,632
Property and equipment, net	\$ 662,054	\$ 688,953

4. RETIREMENT PLANS

The Kentucky employees of the Council who work more than 100 hours per month participate in a defined benefit plan administered by the Kentucky Employees Retirement Systems (KERS) of the Commonwealth of Kentucky, a multiple-employer public employee retirement system. Payroll for Council employees covered by KERS for the years ended June 30, 2014 and 2013 totaled approximately \$5,000,000 and \$5,100,000, respectively.

Covered employees hired before September 1, 2008 who retire at or after age 65, with 48 months of credited service, are entitled to an annual retirement benefit equal to 1.97% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's average of the five fiscal years during which the employee had the highest average monthly salary.

KERS participants have a fully vested interest after completion of 60 months of service, twelve months of which are current service. At a minimum, terminated employees are refunded their contributions with credited interest of 2.50% less contributions to the KERS Insurance Fund. Vested employees may retire after 27 years of service and receive full benefits or retire after age 55 or after 25 years of service and receive reduced retirement benefits. The KERS also provides death and disability benefits. Benefits are established by state statute.

Covered employees hired after September 1, 2008 who retire, at or after age 65 with a minimum of 60 months of credited service or when the employee's age plus their years of service credit equal 87 and they are at least 57 years of age, are entitled to an annual retirement benefit equal to 1.10% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's highest salaried five years. The employee may also be eligible for a reduced retirement benefit at 60 years of age and a minimum of 120 months of credited service. The KERS also provides death and disability benefits. Benefits are established by state statute.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

Covered employees hired before September 1, 2008 are required by state statute to contribute 5.00% of their salaries to the plan. Covered employees hired after September 1, 2008 are required to contribute 5.00% of their salaries to the plan and 1.00% to the KERS Insurance Fund. The Council is required by the same statute to contribute 26.79% and 23.61% of the covered employee's salary for the years ended June 30, 2014 and 2013, respectively. Contributions for the years ended June 30, 2014 and 2013 were approximately \$1,340,000 and \$1,205,000, respectively. These amounts were equal to 100% of the required contributions for each year. The Council's required annual contributions represent less than five percent of total net contributions to the KERS plan.

Benefits under the KERS plan will vary based on final compensation, years of service, and other factors as fully described in the KERS plan documents.

The "pension benefit obligation" is a standardized disclosure measurement of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measurement, which is the actuarial present value of credited projected benefits, is intended to help users assess the pensions' funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among the plans and employers.

Through its most recently issued comprehensive annual financial report, KERS has not made separate measurements of assets and pension benefit obligation for individual employers. The following table presents certain information regarding the plans' status as a whole, derived from actuarial valuations performed as of the dates indicated:

Kentucky Employees Retirement System (Non-Hazardous Members)		
	June 30, 2013	June 30, 2012
Assets available for plan benefits, at fair value	\$ 3,020,939,000	\$ 3,101,317,000
Pension benefit obligation	(11,771,418,000)	(11,361,048,000)
	<u>\$ (8,750,479,000)</u>	<u>\$ (8,259,731,000)</u>
Funded ratio on actuarial value of assets	25.66%	27.30%

Ten-year historical trend information showing KERS's progress in accumulating assets to pay benefits when due is presented in its June 30, 2013 and June 30, 2012 comprehensive annual financial reports at <https://kyret.ky.gov/governance/Pages/transparency.aspx>.

As the Council is only one of several employers participating in the KERS program, it is not practicable to determine the Council's portion of the unfunded past service cost or the vested benefits of the Council's portion of the plan assets. The taxpayer ID number for KERS is 61-6027950.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

In addition to the above defined benefit pension plan, a voluntary defined contribution plan is offered to all employees. Employees who participate may contribute either 2.00% or 5.00% of their salary into a tax-deferred annuity plan. Employees who elect to contribute 2.00% to shall receive a matching contribution by the Council of 4.00%. Employees who elect to contribute 5.00% shall receive a matching contribution by the Council of 10.00%. Employees who elect to participate in both KERS and the defined contribution plan will not receive a matching contribution from the Council to their defined contribution plan when the KERS mandated employer contribution meets or exceeds 10.00%.

Upon completion of 20 years of service, the Council will make an additional 10.00% contribution for no more than 5 years provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council reserves the right to extend this period for certain employees. The Council reserves the right to make additional Council plan contributions for the Executive Director provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council's contributions to the voluntary defined contribution plan amounted to approximately \$945,000 and \$900,000 in 2014 and 2013, respectively.

5. LEASE COMMITMENTS

The Council is obligated under various operating leases for offices and equipment rentals, which expire on various dates through 2022. Rent expense was approximately \$1,867,000 and \$1,495,000 in 2014 and 2013, respectively. Amounts for rent and property maintenance on the accompanying financials are net of recoveries from managed organizations.

Future gross minimum lease payments (assuming there are no managed organizations sharing in future rent expenses) as of June 30, 2014 are as follows (amounts rounded):

2015	\$	1,246,000
2016		1,258,000
2017		1,174,000
2018		1,181,000
2019		1,097,000
Thereafter		2,653,000
	\$	<u>8,609,000</u>

Rental income associated with subleased office space was approximately \$76,000 and \$165,000, respectively, for the years ended June 30, 2014 and 2013.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

6. GRANTS AND CONTRACTS

The Council has entered into agreements with various agencies of the United States Government and other organizations. The purpose of the agreements is to perform research and related projects, or assist in defraying expenses for projects undertaken by the Council. The grants and contracts are subject to various expenditure restrictions and are subject to examination by the granting agency to determine compliance with the related agreements.

Should any expenditure be disallowed, the Council would be required to refund disallowed amounts. For purposes of the accompanying financial statements, a provisional rate for indirect costs has been used as prescribed by the appropriate grantors. The proposal for final indirect cost rate for fiscal year 2014 is currently in process. As such, no provision for refund has been accrued in the accompanying financial statements.

Some grants contain provisions which require the Council and its grantees to contribute matching funds or in-kind services to the grant sponsored project. Matching funds and in-kind services were approximately \$62,000 and \$170,000 for the years ended June 30, 2014 and 2013, respectively.

7. FUNCTIONAL CLASSIFICATION

Following are expenses by functional classifications for the years ended June 30:

	2014	2013
Program expenses	\$ 29,398,119	\$ 28,479,946
Support expenses	1,899,606	1,627,587
Fundraising expenses	166,673	124,766
	<u>\$ 31,464,398</u>	<u>\$ 30,232,299</u>

8. CONCENTRATIONS

The Council maintained approximately \$10,060,000 and \$9,260,000 in an overnight repurchase agreement collateralized by securities at June 30, 2014 and 2013, respectively. Money market funds, as discussed in Note 2, are maintained at various federally insured banks. The balance at each bank does not exceed the federally insured limit of \$250,000.

The Council maintains cash and certificate of deposit accounts with federally insured banks primarily in Lexington, Kentucky. At June 30, 2014 and 2013, approximately \$175,000 and \$172,000, respectively, was uninsured. Subsequent to June 30, 2014, the Council has implemented procedures to alleviate all instances of uninsured cash balances.

For the year ended June 30, 2014, approximately 50 percent of all revenues were from federal grants. For the year ended June 30, 2013, approximately 51 percent of all revenues were from federal grants.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

9. INCOME TAXES

The Council is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (the Code). However, income from certain activities not directly related to the Council's tax-exempt purpose is subject to taxation as unrelated business income. In addition, the Council has been determined by the Internal Revenue Service not to be a private foundation within the context of Section 509(a) of the Code.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Council and recognize a tax liability if the Council has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the Council, and has concluded that as of June 30, 2014 and 2013, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements. The Council is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The Council has filed its federal income tax returns for periods through June 30, 2013. These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

10. FAIR VALUE MEASUREMENTS

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Council has the ability to access.
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2014 AND 2013

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at June 30, 2014 and 2013.

- **Mutual funds:** Valued at the daily closing price as reported by the fund. Mutual funds held by the Council are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Council are deemed to be actively traded.
- **Money market funds:** Generally transact subscription and redemption activity at a \$1 stable net asset value (NAV) however, on a daily basis the funds are valued at their daily NAV calculated using the amortized cost of the securities held in the fund.

The Council accounts for transfers between the levels within the fair value hierarchy at the end of the reporting period. There were no changes in the valuation methods used during 2014 or 2013, and there were no transfers between classes reported.

Following is a summary of assets measured at fair value on a recurring basis as of June 30, 2014.

	<u>Level 1</u>	<u>Level 2</u>
Equity mutual funds	\$ 1,006,749	\$ 0
Fixed income mutual funds	526,275	0
Money market funds	0	17,515,178
	<u>\$ 1,533,024</u>	<u>\$ 17,515,178</u>

Following is a summary of assets measured at fair value on a recurring basis as of June 30, 2013.

	<u>Level 1</u>	<u>Level 2</u>
Equity mutual funds	\$ 804,223	\$ 0
Fixed income mutual funds	500,396	0
	<u>\$ 1,304,619</u>	<u>\$ 0</u>

Desegregated information regarding the above items is included in Note 2.

- SUPPLEMENTARY INFORMATION -

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF FINANCIAL POSITION

JUNE 30, 2014

	CSG	Grants	Eliminations	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 8,916,158	\$	\$	\$ 8,916,158
Receivables:				
Grants and contracts		2,969,428		2,969,428
Publications, net	89,169			89,169
Appropriations	79,246			79,246
Due from managed organizations	90,089			90,089
Due from CSG/Grants		(710,652)	710,652	0
Prepaid expenses	174,572	66		174,638
Total current assets	9,349,234	2,258,842	710,652	12,318,728
Noncurrent assets:				
Investments	19,222,745			19,222,745
Property and equipment, net	662,054			662,054
Total noncurrent assets	19,884,799	0	0	19,884,799
Total assets	\$ 29,234,033	\$ 2,258,842	\$ 710,652	\$ 32,203,527
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,396,925	\$	\$	\$ 1,396,925
Accrued salaries	752,858			752,858
Accrued vacation and sick pay	1,564,322			1,564,322
Due to CSG/Grants	(710,652)		710,652	0
Due to managed organizations	15,261,738			15,261,738
Deferred revenue	1,406,690	2,258,842		3,665,532
Other accrued expenses	485,774			485,774
Total current liabilities	20,157,655	2,258,842	710,652	23,127,149
Unrestricted net assets:				
Undesignated	8,014,324			8,014,324
Board designated, policy programming	300,000			300,000
Board designated, building fund	100,000			100,000
Investment in property and equipment, net	662,054			662,054
Total net assets	9,076,378	0	0	9,076,378
Total liabilities and net assets	\$ 29,234,033	\$ 2,258,842	\$ 710,652	\$ 32,203,527

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF FINANCIAL POSITION JUNE 30, 2013

	CSG	Grants	Eliminations	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 8,389,733	\$	\$	\$ 8,389,733
Receivables:				
Grants and contracts		2,358,668		2,358,668
Publications, net	200,241			200,241
Appropriations	126,000			126,000
Interest receivable	55,027			55,027
Due from managed organizations	101,178			101,178
Due from CSG/Grants		(441,359)	441,359	0
Prepaid expenses	209,092			209,092
Total current assets	9,081,271	1,917,309	441,359	11,439,939
Noncurrent assets:				
Investments	18,753,766			18,753,766
Property and equipment, net	688,953			688,953
Total noncurrent assets	19,442,719	0	0	19,442,719
Total assets	\$ 28,523,990	\$ 1,917,309	\$ 441,359	\$ 30,882,658
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,314,447	\$	\$	\$ 1,314,447
Accrued salaries	673,285			673,285
Accrued vacation and sick pay	1,428,784			1,428,784
Due to CSG/Grants	(441,359)		441,359	0
Due to managed organizations	15,176,440			15,176,440
Deferred revenue	740,437	1,917,309		2,657,746
Other accrued expenses	386,239			386,239
Total current liabilities	19,278,273	1,917,309	441,359	21,636,941
Unrestricted net assets:				
Undesignated	8,256,764			8,256,764
Board designated	300,000			300,000
Investment in property and equipment, net	688,953			688,953
Total net assets	9,245,717	0	0	9,245,717
Total liabilities and net assets	\$ 28,523,990	\$ 1,917,309	\$ 441,359	\$ 30,882,658

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF ACTIVITIES YEAR ENDED JUNE 30, 2014

	CSG	Grants	Eliminations	Total
Revenues:				
Grants and contracts	\$	\$ 15,533,034	\$	\$ 15,533,034
Appropriations and membership dues	6,624,285	16,667		6,640,952
Foundation and project revenue		4,296,420		4,296,420
Contributions	939,696	232,020		1,171,716
Corporate associates	1,149,000			1,149,000
Service recovery	609,730		585,566	1,195,296
Sales of publications	155,750			155,750
Interest and dividends	258,645	0		258,645
Conference center rental	75,677			75,677
Meeting and conference registrations	159,319	12,400		171,719
Net realized and unrealized gains on investments	193,520			193,520
Other	49,481	1,849		51,330
Grantee matching contributions		62,145	(62,145)	0
Donated facilities	402,000			402,000
Total revenues	<u>10,617,103</u>	<u>20,154,535</u>	<u>523,421</u>	<u>31,295,059</u>
Expenses:				
Salaries and wages	6,237,235	7,759,498		13,996,733
Employee benefits	2,144,905	1,826,103		3,971,008
Travel and conferences	1,413,480	2,408,445		3,821,925
Consultant and contract services	630,878	4,406,078		5,036,956
Office expenses	662,349	715,444		1,377,793
Rent and property maintenance	540,452	894,977		1,435,429
Contributions to managed organizations	543,721			543,721
Printing and publications	239,267	60,763		300,030
Equipment maintenance	330,665	73,220		403,885
Depreciation	174,918			174,918
In-kind donations, rent expense	402,000			402,000
	<u>13,319,870</u>	<u>18,144,528</u>	<u>0</u>	<u>31,464,398</u>
Grantee contributions		62,145	(62,145)	0
CSG contribution	(142,007)	142,007		0
Indirect costs recovered:				
Grants	(1,805,855)	1,805,855		0
Allocated	(49,076)		49,076	0
Managed organizations	(536,490)		536,490	0
Total expenses	<u>10,786,442</u>	<u>20,154,535</u>	<u>523,421</u>	<u>31,464,398</u>
Change in net assets	(169,339)	\$ 0	\$ 0	(169,339)
Net assets, beginning of year	<u>9,245,717</u>			<u>9,245,717</u>
Net assets, end of year	<u>\$ 9,076,378</u>			<u>\$ 9,076,378</u>

THE COUNCIL OF STATE GOVERNMENTS

COMBINING STATEMENT OF ACTIVITIES YEAR ENDED JUNE 30, 2013

	CSG	Grants	Eliminations	Total
Revenues:				
Grants and contracts	\$	\$ 15,809,776	\$	\$ 15,809,776
Appropriations and membership dues	6,733,457	21,667		6,755,124
Foundation and project revenue		5,457,025		5,457,025
Contributions	889,223	113,582		1,002,805
Corporate associates	817,000			817,000
Service recovery	566,686		129,599	696,285
Interest and dividends	288,255	53		288,308
Sales of publications	294,732			294,732
Meeting and conference registrations	162,190	1,150		163,340
Conference center rental	165,093			165,093
Net realized and unrealized gains on investments	115,374			115,374
Other	19,224	3,418		22,642
Grantee matching contributions		170,218	(170,218)	0
Donated facilities	280,000			280,000
Total revenues	10,331,234	21,576,889	(40,619)	31,867,504
Expenses:				
Salaries and wages	6,364,309	7,123,303		13,487,612
Employee benefits	2,082,240	1,777,743		3,859,983
Travel and conferences	1,307,646	2,950,628		4,258,274
Consultant and contract services	514,889	4,169,286		4,684,175
Office expenses	687,625	706,633		1,394,258
Rent and property maintenance	606,086	859,747		1,464,833
Contributions to managed organizations	188,188			188,188
Printing and publications	297,027	74,035		371,062
Equipment maintenance	223,967	101,911		325,878
Depreciation	198,036			198,036
In-kind donations, rent expense	280,000			280,000
	12,749,013	17,763,286	0	30,512,299
Grantee contributions		170,218	(170,218)	0
CSG contribution	(273,207)	273,207		0
Indirect costs recovered:				
Grants	(3,370,178)	3,370,178		0
Allocated	414,522		(414,522)	0
Managed organizations	(544,121)		544,121	0
Total expenses	8,976,029	21,576,889	(40,619)	30,512,299
Change in net assets	1,355,205	\$ 0	\$ 0	1,355,205
Net assets, beginning of year	7,890,512			7,890,512
Net assets, end of year	\$ 9,245,717		\$	\$ 9,245,717

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF DUE FROM MANAGED ORGANIZATIONS JUNE 30, 2014 AND 2013

	<u>2014</u>	<u>2013</u>
National Association of State Treasurers Foundation, Inc.	\$ 88,521	\$ 96,180
National Association of State Treasurers - Restricted	1,568	0
Eastern Regional Conference	<u>0</u>	<u>4,998</u>
Total due from managed organizations	\$ <u>90,089</u>	\$ <u>101,178</u>

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF DUE TO MANAGED ORGANIZATIONS JUNE 30, 2014 AND 2013

	2014	2013
21st Century Fund	\$ 153,665	\$ 233,393
American Probation and Parole Association	390,535	228,533
American Probation and Parole Association - Restricted Fund	24,229	13,829
American Probation and Parole Association - Services Account	86,554	67,407
Association of Air Pollution Control	5,540	0
Bowhay Institute of Legislative Leadership Development	244,672	228,795
Council of State Governments - West	116,348	254,034
Council of State Governments West Meetings	114,909	78,683
Eastern Regional Conference	152,933	0
Eastern Trade Council	237,767	212,465
Emergency Management Accreditation Program	850,034	712,347
Interstate Commission for Juveniles	1,458,981	1,311,091
Interstate Commission on Adult Offender Supervision	1,768,232	2,319,707
Interstate Commission on Educational Opportunity for Military Children	924,273	743,212
Midwest Legislative Conference	831,479	749,089
Midwest Passenger Rail Commission	210,675	138,063
Minds Against Crime	18,019	17,966
National Association of State Facilities Admin. - Eastern Region	3,223	3,216
National Association of State Facilities Admin. - Great Plains	6,007	7,788
National Association of State Facilities Admin. - Southeast Region	5,833	4,929
National Association of State Facilities Admin. - Western Region	3,635	8,216
National Association of State Facilities Administrators	415,954	473,670
National Association of State Personnel Executives, Inc.	403,179	397,278
National Association of State Technology Directors	640,884	719,285
National Association of State Technology Directors - Eastern Region	134,758	82,699
National Association of State Technology Directors - Midwest Region	60,711	39,064
National Association of State Technology Directors - Southern Region	106,544	59,655
National Association of State Technology Directors - Western Region	116,339	89,779
National Association of State Treasurers	888,769	844,610
National Association of State Treasurers - College Savings Plan	350,579	350,579
National Association of State Treasurers - State Debt Management Network	83,019	83,019
National Association of State Treasurers - Restricted	0	595
National Emergency Management Association	654,328	1,339,576
National Hispanic Caucus of State Legislators	1,547,182	1,068,290
National Hispanic Caucus of State Legislators - Restricted Fund	517,148	442,383
National Lieutenant Governors Association	0	57,123
Northeast States Association for Agriculture Stewardship	64,133	33,075
Southern Legislative Conference	589,703	600,959
Southern Legislative Conference - Host State Accounts	362,924	564,119
State International Development Organization	244,848	241,691
Western Designated Fund	370,000	195,000
Western Legislative Academy	102,193	161,228
Total due to managed organizations	\$ 15,261,738	\$ 15,176,440

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2014

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA, or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
<u>Major Programs:</u>				
U.S. Department of Justice	145-161-70-11818	16,745	1,076,444	311,073
Supporting Effective Responses	145-161-70-11819	16,745	969,318	738,280
State Based Capacity Building	150-161-70-10699	16,751	473,374	(1,604)
Responses to Those with Mental Illness	150-085-70-11455	16,751	500,000	53,906
Discovering Corrections Website Project	150-085-70-11587	16,751	1,000,000	73,663
Correction Information Sharing	150-161-70-11598	16,751	7,968,189	1,909,939
Justice Reinvestment Technology Assistance for States	150-161-70-11599	16,751	1,298,821	169,679
Mental Health Curriculum				
Bringing Network for the Improvement of				
Addiction Treatment to Corrections	150-161-70-11716	16,751	348,691	64,674
Law & Mental Health Data Collection	150-161-70-11596	16,751	428,122	38,596
Justice Reinvestment Initiative Intensive Tech Assistance	150-161-70-11912	16,751	3,063,533	1,079,184
Center for Effective Public Policy	150-161-70-11943	16,751	11,178	11,178
National Re-entry Resource Center	145-161-70-11820	16,812	9,880,410	3,945,208
			<u>27,018,080</u>	<u>8,393,776</u>
U.S. Department of Homeland Security				
Emergency Management Baseline Assessments Grant	330-146-70-11833	97,131	600,000	230,108
			<u>27,618,080</u>	<u>8,623,884</u>
<u>Total major programs</u>				
<u>Nonmajor programs:</u>				
U.S. Agency for International Development				
US/Mexico State Alliance Partnership	150-070-70-10552	523-A-00-08-00010-00 \$	17,900,000	665,387
U.S. Department of Defense				
Federal Voting Assistance Program	150-050-70-11928	H98210-13-2-0002	3,240,117	80,350

See report of independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2014

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
<u>U.S. Army Corps of Engineering</u>				
<u>U.S. Army Corps of Engineering</u>	330-146-70-11453	W91278-09-C-0082	335,135	186,753
<u>U.S. Department of Energy</u>				
Radioactive Waste Transportation Project	10373/10348	81.065	2,623,239	(2,501)
Radioactive Waste Transportation Project	11792	81.106	300,511	239,416
Radioactive Waste Transportation Project	11850	81.106	190,825	97,500
Radioactive Waste Transportation Project	11856	81.106	64,772	32,059
Energy Efficiency and Renewable Energy Information Dissemination, Outreach, Training and Technical Analysis (1)	11961	81.117	60,000	2,636
Radioactive Waste Transportation Project	11793	81.122	625,000	120,948
Radioactive Waste Transportation Project	11794	81.122	575,000	140,354
			4,439,347	630,412
<u>U.S. Department of Health and Human Services</u>				
Engaging state and local emergency management associations to improve states ability	415-090-70-11817	93.069	97,549	6,368
Joint Policy Group	415-090-70-11923	93.069	100,000	44,795
National Association of State Emergency Medical Services Officials	150-050-70-11845	HSHQDC-12-C-00128	110,409	28,656
Traditional Guidelines (2)	145-161-70-11879	HHSS2832007000031	50,000	42,321
Community Outreach	415-090-70-11822	HSFE60-12-P-0247	24,951	24,951
Substance Abuse and Mental Health Services Administration (3)	145-161-70-11954	02500-SAMHSA- STSTE-TA-AHP	8,000	4,776
			390,909	151,867
<u>U.S. Department of Homeland Security</u>				
Urban Search & Rescue	330-146-70-11937	HSFE20-13-P-0285	200,000	74,868
Homeland Technical Assistance Program	415-090-70-11610	97.007	1,775,872	469,879
National Incident Management Systems	415-090-70-11609	97.107	4,000,000	1,687,584
			5,975,872	2,232,331

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2014

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
U.S. Department of Justice				
Supervision of Partner Abuse	150-085-70-10630	16.008	781,894	30,668
Offender is a Victim - Office on Violence Against Women	150-085-70-11825	16.526	225,000	24,983
Office of Juvenile Justice and Delinquency Prevention Workgroup (4)	150-085-70-11797	16.540	20,000	5,584
Effective School Policies and Practices	150-161-70-11718	16.541	840,000	168,476
National Institute of Justice Home Visits Study (5)	150-085-70-11973	16.560	10,159	836
Bureau of Justice Assistance - Technical Assistance	150-161-70-10673	16.580	373,637	9,996
Improving Law Enforcement	150-161-70-10697	16.580	249,049	(933)
Tribal Correctional Options	150-085-70-11465	16.580	400,000	41,047
Improving Criminal Justice Info Sharing	150-161-70-11456	16.580	296,838	135,552
Discovering Corrections Website Project	150-161-70-11594	16.580	400,000	88,019
State-based Capacity Building	150-161-70-11595	16.580	1,562,468	(24,920)
Supporting Effective Responses	150-161-70-11597	16.580	1,516,405	(35,782)
Tribal Probation Training	150-085-70-11605	16.580	300,000	80,472
Tribal Probation Academy (6)	150-085-70-11648	16.580	44,829	12,308
National Re-entry Resource Center	150-161-70-11608	16.580	12,388,562	1,670,335
Project Safe Neighborhoods - Technology Technical Assistance Program	150-085-70-11717	16.580	200,000	108,750
Tribal Probation Academy - III (6)	150-085-70-11869	16.580	30,000	4,408
Training (7)	150-085-70-11777	16.590	5,000	787
Training Curriculum Development	150-085-70-11821	16.601	90,264	69,419
Intermediate Training on Effective Case Management	150-085-70-11463	16.608	417,802	35,739
Tribal Court	150-085-70-11816	16.608	826,511	66,597
Community Strategic Planning (6)	150-085-70-11859	16.608	60,206	16,652
Project Safe Neighborhood	150-085-70-11593	16.609	148,529	15,121
Indian Alcohol and Substance Abuse (6)	150-085-70-11647	16.616	44,829	4,099
Re-entry Implementation Guidance	150-161-70-10676	16.710	249,413	(586)
Enhancing Re-entry Initiatives	150-161-70-11741	16.710	10,450	(73)
Citizens Against Physical and Sexual Abuse (4)	150-085-70-11783	16.734	20,000	5,594
Resource Center for the Elimination of Prison Rape (8)	150-085-70-11813	16.735	104,230	24,132

See report of independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2014

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenditures</u>
Community Corrections Problem Solving Public Safety, ARRA	150-085-70-11435	16.738	669,677	147,579
Training for Community Corrections, ARRA	150-161-70-11750	16.803	287,396	(12,604)
Tribal Civil and Criminal Assistance	150-085-70-11434	16.807	357,731	(3,060)
	150-085-70-11815	16.815	498,559	164,079
			<u>23,429,438</u>	<u>2,853,274</u>
U.S. Department of Transportation				
Driving While Intoxicated Risk Assessment Tools, Curriculum and Training	150-085-70-10636	20.216	489,382	25,003
National Highway Traffic Safety Administration Probation Fellow	150-085-70-11429	20.614	435,000	83,773
			<u>924,382</u>	<u>108,776</u>
Total nonmajor programs			<u>56,635,200</u>	<u>6,909,150</u>
Total all programs			<u>\$ 84,253,280</u>	<u>\$ 15,533,034</u>

ARRA - American Recovery and Reinvestment Act

- (1) - Passed through from Mid-America Regional Council.
- (2) - Passed through from Policy Research Associates.
- (3) - Passed through from Advocates for Human Potential.
- (4) - Passed through from Westat Corporation.
- (5) - Passed through from Abt Associates, Inc.
- (6) - Passed through from Fox Valley Technical College.
- (7) - Passed through from Lexington-Fayette Urban County Government.
- (8) - Passed through from National Center for Crime and Delinquency.

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2014

1. GENERAL

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the Council of State Governments (the Council). The Council's reporting entity is defined in Note 1 to the Council's financial statements. All federal financial assistance was received directly from federal agencies unless specifically noted on the schedule.

The grant revenue amounts received and expensed are subject to audit and adjustment. If any expenditures are disallowed by the grantor as a result of such an audit, any claim for reimbursement to the grantor would become a liability of the Council. In the opinion of management, all grant expenditures are in compliance with the terms of the grant agreements and applicable federal laws and regulations.

2. BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Council and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some of the amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

3. SUBRECIPIENTS

Of the federal expenditures presented in the schedule, the Council provided federal awards to subrecipients as follows:

Subrecipient	CFDA Number or Other Identifying Number	Amount
Urban Institute	16.580	331,130
Center for Employment	16.580	213,711
Center for Effective Public Policy	16.580	163,569
Fox Valley Technical College	16.580	159,801
Heartland Alliance	16.580	138,267
Pretrial Justice Institute	16.608	93,427
Fox Valley Technical College	16.608	93,100
Policy Research Associates, Inc.	16.745	90,133
Policy Research Associates, Inc.	16.745	87,260
Ohio Department of Rehabilitation	16.751	78,091
New Hampshire Department of Corrections	16.751	63,000
Hawaii Department of Public Safety	16.751	60,830
National Consortium	16.751	60,130
University of Wisconsin - Madison	16.751	56,881
Center for Social Innovation	16.751	50,000

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2014

Subrecipient	CFDA Number or Other Identifying Number	Amount
North Carolina Department of Public Safety	16.751	49,921
Urban Institute	16.812	49,918
Council of Juvenile Correctional Administrators	16.812	48,998
University of North Dakota	16.815	48,927
National Judicial College	16.815	47,608
Iowa Department of Public Health	81.106	44,110
Illinois Department of Emergency Management	81.106	34,829
Governor's Office of Louisiana	97.107	31,667
Kentucky State Treasurer	97.107	25,022
Utah Division of Emergency	97.107	24,934
Pennsylvania Department of Emergency Management	97.107	24,520
Michigan Department of Emergency Management	97.107	24,056
Louisiana State University	97.107	22,380
Georgia Tech Applied Research Corporation	97.107	22,378
Arizona Department of Emergency	97.107	19,623
Virginia Department of Emergency	97.107	18,950
Massachusetts Department of Emergency Management	97.107	18,307
Alabama Emergency Management	97.107	17,917
Idaho Department of Emergency Management	97.107	17,585
Missouri Office of Homeland Security	97.107	17,505
Washington Military Department	97.107	16,592
Arizona Department of Emergency	97.107	16,525
Iowa Department of Homeland Security	97.107	15,517
Oklahoma Department of Emergency Management	97.107	15,500
University of Illinois	16.751 and 16.738	15,450
Policy Research Associates, Inc.	16.751 and 16.738	15,032
Woodrow Wilson International Center for Scholars	523-A-00-08-00010-00	13,532
Conference of Western Attorneys General	523-A-00-08-00010-00	11,725
United States - Mexico Border Philanthropy Partnership	523-A-00-08-00010-00	11,498
National Association of State Treasurers	523-A-00-08-00010-00	11,363
Other	Various	101,501
Total federal awards passed through to subrecipients		\$ 2,592,720



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**REPORT OF INDEPENDENT AUDITORS ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT
AUDITING STANDARDS**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of The Council of State Governments (a nonprofit organization, the Council) which comprise the statement of financial position as of June 30, 2014, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated December 10, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Council's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Council's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Council's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Council's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Blue & Co., LLC

Lexington, Kentucky
December 10, 2014



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**REPORT OF INDEPENDENT AUDITORS ON COMPLIANCE FOR EACH
MAJOR FEDERAL PROGRAM AND ON INTERNAL CONTROL
OVER COMPLIANCE REQUIRED BY OMB CIRCULAR A-133**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Report on Compliance for Each Major Federal Program

We have audited The Council of State Governments (a nonprofit organization, the Council) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Council's major federal programs for the year ended June 30, 2014. The Council's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of the Council's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Council's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of the Council's compliance.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Opinion on Each Major Federal Program

In our opinion, the Council complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2014.

Report on Internal Control Over Compliance

Management of the Council is responsible for establishing and maintaining effective internal control over compliance with the types of requirements referred above. In planning and performing our audit of compliance, we considered the Council's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Blue & Co., LLC

Lexington, Kentucky
December 10, 2014

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS YEAR ENDED JUNE 30, 2014

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unmodified

Internal Control over financial reporting:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Noncompliance material to financial
statements noted?

_____ yes X no

Federal Awards

Internal control over major programs:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Type of auditor's report issued on compliance for major programs: unmodified

Any audit findings disclosed that are
required to be reported in accordance
with section 510(a) of Circular A - 133?

_____ yes X no

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS YEAR ENDED JUNE 30, 2014

The Council's major federal programs for the year ended June 30, 2014 were:

CFDA No. 16.745:

Criminal and Juvenile Justice and Mental Health Collaboration Program

CFDA No. 16.751:

Edward Byrne Memorial Competitive Grant Program - See individual grant descriptions on Schedule of Expenditures of Federal Awards.

CFDA No. 16.812:

Second Chance Act Prisoner Reentry Initiative - National Re-entry Resource Center

CFDA No. 97.131:

Emergency Management Baseline Assessments Grant

The dollar threshold used to distinguish between Type A and Type B programs was \$465,991.

The Council qualified as a low-risk auditee under the provisions of OMB Circular A-133.

Section II - Findings - Financial Statement Audit

None reported.

Section III - Findings and Questioned Costs - Major Federal Awards Program Audit

None reported.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF PRIOR YEAR FINDINGS AND THEIR RESOLUTIONS YEAR ENDED JUNE 30, 2013

No findings or questioned costs were reported for the year ended June 30, 2013.



**THE COUNCIL OF
STATE GOVERNMENTS**

**FINANCIAL STATEMENTS AND
REPORT OF INDEPENDENT AUDITORS**

JUNE 30, 2013 AND 2012

THE COUNCIL OF STATE GOVERNMENTS

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REPORT OF INDEPENDENT AUDITORS

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of The Council of State Governments (a nonprofit organization, the Council), which comprise the statements of financial position as of June 30, 2013 and 2012, and the related statements of activities and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Council as of June 30, 2013 and 2012, and the changes in its net assets and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Report on Supplementary Information

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The accompanying schedule of expenditures of federal awards, as required by *Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* is presented for purposes of additional analysis and is not a required part of the financial statements. The combining statements of financial position and activities, and the schedules of amounts due to and due from managed organizations are presented for purposes of additional analysis and are not a required part of the financial statements. The combining information on pages 15 through 18 is presented for purposes of additional analysis rather than to present the financial position, results of operations, and cash flows of the individual departments the Council. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the Council's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Council's internal control over financial reporting and compliance.

Blue & Co., LLC

Lexington, Kentucky
December 5, 2013

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF FINANCIAL POSITION
JUNE 30, 2013 AND 2012

	<u>2013</u>	<u>2012</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 8,389,733	\$ 6,322,560
Receivables:		
Grants and contracts	2,358,668	3,188,453
Publications, net of allowance for uncollectible accounts of \$20,000 for 2013 and 2012	200,241	179,507
Appropriations	126,000	287,856
Interest receivable	55,027	52,028
Due from managed organizations	101,178	116,928
Prepaid expenses	209,092	247,914
Total current assets	<u>11,439,939</u>	<u>10,395,246</u>
Noncurrent assets:		
Investments	18,753,766	18,426,016
Property and equipment, net	688,953	771,277
Total noncurrent assets	<u>19,442,719</u>	<u>19,197,293</u>
Total assets	<u>\$ 30,882,658</u>	<u>\$ 29,592,539</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 1,314,447	\$ 1,329,486
Accrued salaries	673,285	706,941
Accrued compensated absences	1,428,784	1,252,394
Due to managed organizations	15,176,440	15,388,687
Deferred revenue	2,657,746	2,453,152
Other accrued expenses	386,239	571,367
Total current liabilities	<u>21,636,941</u>	<u>21,702,027</u>
Unrestricted net assets:		
Undesignated	8,256,764	6,819,235
Board designated	300,000	300,000
Investment in property and equipment, net	688,953	771,277
Total net assets	<u>9,245,717</u>	<u>7,890,512</u>
Total liabilities and net assets	<u>\$ 30,882,658</u>	<u>\$ 29,592,539</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF ACTIVITIES
YEARS ENDED JUNE 30, 2013 AND 2012

	<u>2013</u>	<u>2012</u>
Revenues:		
Grants and contracts	\$ 15,809,776	\$ 13,555,785
Appropriations and membership dues	6,755,124	6,304,540
Foundation and project revenue	5,457,025	4,220,285
Contributions	1,002,805	1,200,494
Corporate associates	817,000	812,000
Service recovery	696,285	724,751
Sales of publications	294,732	264,666
Interest and dividends	288,308	352,687
Conference center rental	165,093	164,113
Meeting and conference registrations	163,340	179,050
Net realized and unrealized gains on investments	115,374	48,387
Other	22,642	78,886
Total revenues	<u>31,587,504</u>	<u>27,905,644</u>
Expenses:		
Salaries and wages	13,487,612	11,807,448
Employee benefits	3,859,983	3,461,327
Consultant and contract services	4,684,175	4,353,455
Travel and conferences	4,258,274	4,523,585
Rent and property maintenance	1,464,833	1,294,013
Office expenses	1,394,258	1,358,540
Printing and publications	371,062	360,082
Equipment maintenance	325,878	357,990
Depreciation	198,036	199,203
Contributions to managed organizations	188,188	241,448
Total expenses	<u>30,232,299</u>	<u>27,957,091</u>
Change in net assets	1,355,205	(51,447)
Net assets, beginning of year	<u>7,890,512</u>	<u>7,941,959</u>
Net assets, end of year	<u>\$ 9,245,717</u>	<u>\$ 7,890,512</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2013 AND 2012

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Change in net assets	\$ 1,355,205	\$ (51,447)
Adjustments to reconcile change in net assets to net cash flows from operating activities:		
Depreciation	198,036	199,203
Realized and unrealized gains on investments	(115,374)	(48,387)
Changes in operating assets and liabilities:		
Accounts receivable - publications	(20,734)	75,462
Accounts receivable - grants and contracts	829,785	(1,211,223)
Accounts receivable - appropriations	161,856	205,257
Interest receivable	(2,999)	148,505
Prepaid expenses	38,822	(46,310)
Accounts payable	(15,039)	32,572
Accrued salaries	(33,656)	107,741
Accrued vacation and sick pay	176,390	127,145
Deferred revenue	204,594	(144,485)
Other accrued expenses	(185,128)	(16,491)
Net cash flows from operating activities	<u>2,591,758</u>	<u>(622,458)</u>
Cash flows from investing activities:		
Proceeds from sales of investments	25,649,923	63,169,144
Purchases of investments	(25,862,299)	(63,819,672)
Change in due from managed organizations	15,750	(68,049)
Proceeds from sales of equipment	14,000	
Purchases of property and equipment	(129,712)	(128,851)
Net cash flows from investing activities	<u>(312,338)</u>	<u>(847,428)</u>
Cash flows from financing activities:		
Change in due to managed organizations	<u>(212,247)</u>	<u>1,644,784</u>
Change in cash and cash equivalents	2,067,173	174,898
Cash and cash equivalents, beginning of year	<u>6,322,560</u>	<u>6,147,662</u>
Cash and cash equivalents, end of year	<u>\$ 8,389,733</u>	<u>\$ 6,322,560</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of The Council of State Governments (the Council) is presented to assist in understanding the Council's financial statements. The financial statements and notes are representations of the Council's management who are responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Description of Organization and Basis of Presentation:

The Council is an unincorporated non-profit, multi-branch organization that serves the states and U.S. territories for the purpose of championing excellence in state government. The Council conducts research on state programs and problems, maintains an information service available to state officials and legislators, issues a variety of publications, acts as a state-federal liaison, promotes regional and state-local cooperation, organizes informative forums and conferences, and provides management services and staff for managed organizations.

The financial statements of the Council have been prepared on the accrual method of accounting. Accordingly, revenues are recognized when they are earned and expenses are recognized when they are incurred.

Governmental grant awards are deemed to be earned and reported as grant revenues when the Council has incurred expenses in compliance with the specific restrictions of the applicable grants. Expenses incurred for which grant funds have not been received are reported as grants receivable, while grant funds received but not yet earned are reported as deferred grant revenue.

Financial Statement Presentation:

The financial statements of the Council have been prepared following the recommendations of Accounting Standards Codification (ASC) 958-205 - *Nonprofit Organization Entities, Presentation of Financial Statements*. Under the provisions set forth therein, net assets, revenues, gains and losses are classified based on the existence or absence of donor-imposed restrictions as follows:

- Unrestricted net assets - Net assets that are not subject to donor-imposed stipulations, and used for various program expenses and general operating functions.
- Temporarily restricted net assets - Net assets subject to donor-imposed stipulations that can be fulfilled by actions of the Council pursuant to those stipulations or that expire by the passage of time.
- Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the Council.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

Use of Estimates:

Management uses estimates and assumptions in preparing the financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and reported revenues and expenses. Actual results could differ from those estimates.

Cash and Cash Equivalents:

For purposes of the statements of cash flows, cash and cash equivalents include cash on hand, cash on deposit, and temporary investments.

Accounts Receivable:

Accounts receivable includes sales of publications and other receivables. Accounts receivable for sales of publications are stated at unpaid balances less allowance for doubtful accounts. Management estimates an allowance for bad debts based on previous collection experience. Specific accounts are written off when internal collection procedures have ended. Receivables are considered past due based on contractual terms and are recorded at net invoice amounts.

Investments and Investment Income:

Investments are reported at fair value and bear interest at various rates depending on the market. Investments are adjusted to market value at reporting dates, and realized and unrealized gains and losses are recorded in the statements of activities.

Property and Equipment:

Property and equipment acquisitions are stated at cost. Depreciation is provided for using the straight-line method over the estimated useful lives of the respective assets, which range from 2 to 20 years. Acquisitions of property and equipment in excess of \$2,000 are capitalized. The cost of repairs and maintenance is expensed as incurred.

Management Services:

The Council provides management services to certain other organizations including cash management and accounting services. Revenue from these arrangements is included in service recovery in the accompanying statements of activities. The Council has included the balances due to or due from the Council on the accompanying statements of financial position.

Under the Council's cash management policies, organizations with amounts due to them are paid interest from investment income at a rate of .75% less than the average return earned by the Council on money market funds and long-term investments if the managed organization participates in the long-term investment pool.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

Organizations with amounts due from them are charged at a rate of .75% more than the average return earned by the Council on short-term investments. Net interest income allocated to these organizations in 2013 and 2012 was approximately \$76,000 and \$137,000, respectively.

Appropriations and Memberships:

The Council is a member-driven association of state elected officials. Appropriations are the dues paid by member states. Each state's dues are based on a flat rate plus a population factor. In addition, there are Canadian provinces that are regional members.

Project Revenue:

Project revenue consists primarily of contracts and similar arrangements with private foundations for various programs and other objectives within the overall mission of the Council.

Corporate Associates:

The Council administers a program which allows representatives of the private sector to participate and offer their perspectives to public sector members. Corporate associates are eligible for appointment to the Council's standing and public policy committees. Corporate associates have the opportunity to interact with state policymakers through national and regional conferences, program and policy work and international exchanges.

Contributions:

Contributions, including unconditional promises to give, are recognized as revenues in the period received and are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and nature of any donor restrictions. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value. Restricted contributions whose restrictions are satisfied in the period the contributions are received are reported as unrestricted contributions. Restricted net assets are reclassified to unrestricted net assets upon satisfaction of the time or purpose restriction.

The Council did not have any donor-restricted contributions during the years ended June 30, 2013 and 2012.

Other Revenue:

All other revenue is recognized when earned.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

Compensated Absences:

It is the Council's policy to permit employees to accumulate earned but unused personal leave and sick pay benefits. Personal leave is accrued when earned. Accrued personal leave totaling approximately \$1,400,000 and \$1,220,000, respectively, as of June 30, 2013 and 2012 is included in the accompanying Statements of Financial Position.

Accrued sick leave totaling approximately \$30,000 and \$33,000 as of June 30, 2013 and 2012, respectively, relates to sick leave earned prior to June 30, 1995 and represents 20% of the unused sick leave at the current rate of pay. Sick leave earned July 1, 1995 and thereafter is not accrued by the Council.

Deferred Revenue:

Deferred revenue at June 30, 2013 and 2012 consists of appropriations, fees for future meetings, deferred lease amounts, and deferred grant income.

Reclassifications:

Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform to the presentation in the current year.

Subsequent Events:

The Council evaluates events occurring subsequent to the date of the financial statements in determining the accounting for and disclosure of transactions and events that affect the financial statements. Subsequent events have been evaluated through December 5, 2013, which is the date the financial statements were available to be issued.

2. INVESTMENTS

The composition of investments consisted of the following at June 30:

	<u>2013</u>	<u>2012</u>
Equity mutual funds:		
Large cap	\$ 662,110	\$ 627,967
Medium cap	98,378	89,972
Small cap	43,735	39,998
Fixed income mutual funds:		
U.S. Treasury and Agency	263,599	241,076
U.S. Corporate	211,567	193,491
Other	25,230	23,074
Certificates of deposit	17,449,147	17,210,438
	<u>\$ 18,753,766</u>	<u>\$ 18,426,016</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

3. PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows at June 30:

	2013	2012
Land	\$ 173,337	\$ 173,337
Buildings and improvements	504,991	489,468
Equipment	1,641,257	1,551,861
Automobiles		40,748
	<u>2,319,585</u>	<u>2,255,414</u>
Less accumulated depreciation	<u>1,630,632</u>	<u>1,484,137</u>
Property and equipment, net	<u>\$ 688,953</u>	<u>\$ 771,277</u>

4. RETIREMENT PLANS

The Kentucky employees of the Council who work more than 100 hours per month participate in a defined benefit plan administered by the Kentucky Employees Retirement Systems (KERS) of the Commonwealth of Kentucky, a multiple-employer public employee retirement system. All payroll for the Council employees covered by KERS for the years ended June 30, 2013 and 2012 totaled approximately \$5,100,000 and \$4,945,000, respectively.

Covered employees hired before September 1, 2008 who retire at or after age 65, with 48 months of credited service, are entitled to an annual retirement benefit equal to 1.97% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's average of the five fiscal years during which the employee had the highest average monthly salary.

KERS participants have a fully vested interest after completion of 60 months of service, twelve months of which are current service. At a minimum, terminated employees are refunded their contributions with credited interest of 2.50% less contributions to the KERS Insurance Fund. Vested employees may retire after 27 years of service and receive full benefits or retire after age 55 or after 25 years of service and receive reduced retirement benefits. The KERS also provides death and disability benefits. Benefits are established by state statute.

Covered employees hired after September 1, 2008 who retire, at or after age 65 with a minimum of 60 months of credited service or when the employee's age plus their years of service credit equal 87 and they are at least 57 years of age, are entitled to an annual retirement benefit equal to 1.10% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's highest salaried five years. The employee may also be eligible for a reduced retirement benefit at 60 years of age and a minimum of 120 months of credited service. The KERS also provides death and disability benefits. Benefits are established by state statute.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

JUNE 30, 2013 AND 2012

Covered employees hired before September 1, 2008 are required by state statute to contribute 5.00% of their salaries to the plan. Covered employees hired after September 1, 2008 are required to contribute 5.00% of their salaries to the plan and 1.00% to the KERS Insurance Fund. The Council is required by the same statute to contribute 23.61% and 19.82% of the covered employee's salary for the years ended June 30, 2013 and 2012, respectively. The contribution requirement for the years ended June 30, 2013 and 2012 was approximately \$1,470,000 and \$1,240,000, respectively, which is equal to 100% of the required contributions for each year. The Council's required annual contributions represent less than five percent of total net contributions to the KERS plan.

Benefits under the KERS plan will vary based on final compensation, years of service, and other factors as fully described in the KERS plan documents.

The "pension benefit obligation" is a standardized disclosure measurement of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measurement, which is the actuarial present value of credited projected benefits, is intended to help users assess the pensions' funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among the plans and employers.

KERS does not make separate measurements of assets and pension benefit obligation for individual employers. The following table presents certain information regarding the plans' status as a whole, derived from actuarial valuations performed as of the dates indicated:

	Kentucky Employees Retirement System (Non-Hazardous Members)	
	June 30, 2012	June 30, 2011
Assets available for plan benefits, at fair value	\$ 3,101,316,738	\$ 3,726,986,087
Pension benefit obligation	(11,361,048,136)	(11,182,142,032)
	<u>\$ (8,259,731,398)</u>	<u>\$ (7,455,155,945)</u>
Funded ratio on actuarial value of assets	27.30%	33.33%

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

Ten-year historical trend information showing KERS's progress in accumulating assets to pay benefits when due is presented in its June 30, 2012 and June 30, 2011 comprehensive annual financial reports at <https://kyret.ky.gov/governance/Pages/transparency.aspx>.

As the Council is only one of several employers participating in the KERS program, it is not practicable to determine the Council's portion of the unfunded past service cost or the vested benefits of the Council's portion of the Plan assets. The taxpayer ID number for KERS is 61-6027950.

In addition to the above defined benefit pension plan, a voluntary defined contribution plan is offered to all employees. Employees who participate in TIAA-CREF may contribute either 2.00% or 5.00% of their salary into a Tax-Deferred Annuity Plan. Employees who elect to contribute 2.00% to TIAA-CREF shall receive a matching contribution by the Council of 4.00%. Employees who elect to contribute 5.00% to TIAA-CREF shall receive a matching contribution by the Council of 10.00%. Employees who elect to participate in both KERS and TIAA-CREF will not receive a matching contribution from the Council to their TIAA-CREF Plan when the KERS mandated employer contribution meets or exceeds 10.00%.

Upon completion of 20 years of service, the Council will make an additional 10.00% contribution for no more than 5 years provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council reserves the right to extend this period for certain employees. The Council reserves the right to make additional Council plan contributions for the Executive Director provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council's contributions to the voluntary defined contribution plan amounted to approximately \$900,000 and \$805,000 in 2013 and 2012, respectively.

5. LEASE COMMITMENTS

The Council is obligated under various operating leases for offices and equipment rentals, which expire on various dates through 2022. Rent expense was approximately \$1,465,000 and \$1,294,000 in 2013 and 2012, respectively. Amounts for rent and property maintenance on the accompanying financials are net of recoveries from managed organizations.

Future gross minimum lease payments (assuming there are no managed organizations sharing in future rent expenses) as of June 30, 2013 are as follows (amounts rounded):

2014	\$	1,285,000
2015		1,280,000
2016		1,255,000
2017		1,090,000
2018		1,100,000
Thereafter		3,460,000
	\$	<u>9,470,000</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

Rental income associated with subleased office space was approximately \$165,000 and \$164,000, respectively, for the years ended June 30, 2013 and 2012. The future minimum sublease rental revenue for non-cancelable sublease agreements are as follows: year ending 2014, approximately \$140,000.

6. GRANTS AND CONTRACTS

The Council has entered into agreements with various agencies of the United States Government and other organizations. The purpose of the agreements is to perform research and related projects, or assist in defraying expenses for projects undertaken by the Council. The grants and contracts are subject to various expenditure restrictions and are subject to examination by the granting agency to determine compliance with the related agreements.

Should any expenditure be disallowed, the Council would be required to refund disallowed amounts. For purposes of the accompanying financial statements, a provisional rate for indirect costs has been used as prescribed by the appropriate grantors. The proposal for final indirect cost rate for fiscal year 2013 is currently in process. As such, no provision for refund has been accrued in the accompanying financial statements.

Some grants contain provisions which require the Council and its grantees to contribute matching funds or in-kind services to the grant sponsored project. Matching funds and in-kind services were approximately \$170,000 and \$2,500,000 for the years ended June 30, 2013 and 2012, respectively.

7. FUNCTIONAL CLASSIFICATION

Following are expenses by functional classifications for the years ended June 30:

	2013	2012
Program expenses	\$ 28,479,946	\$ 26,085,977
Support expenses	1,627,587	1,636,910
Fundraising expenses	124,766	234,204
	<u>\$ 30,232,299</u>	<u>\$ 27,957,091</u>

8. CONCENTRATIONS

The Council maintains its cash accounts with federally insured banks primarily in Lexington, Kentucky. The Council maintained approximately \$9,260,000 and \$6,400,000 in an overnight repurchase agreement collateralized by securities at June 30, 2013 and 2012, respectively. Also, see Note 2 regarding investments in CDs. The Council maintained additional amounts in non-interest bearing accounts at June 30, 2013 and 2012, respectively. From December 31, 2010 through December 31, 2012, at all FDIC-insured institutions, deposits held in noninterest-bearing transaction accounts are fully insured regardless of the amount in the account. As of June 30, 2013 and 2012 all amounts were either insured or collateralized.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

For the year ended June 30, 2013, approximately 50 percent of all revenues were from federal grants. For the year ended June 30, 2012, approximately 49 percent of all revenues were from federal grants.

9. INCOME TAXES

The Council is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (the Code). However, income from certain activities not directly related to the Council's tax-exempt purpose is subject to taxation as unrelated business income. In addition, the Council has been determined by the Internal Revenue Service not to be a private foundation within the context of Section 509(a) of the Code.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Council and recognize a tax liability if the Council has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the Council, and has concluded that as of June 30, 2013 and 2012, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements. The Council is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The Council has filed its federal income tax returns for periods through June 30, 2012. These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

10. FAIR VALUE MEASUREMENTS

The framework for measuring fair value provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are described as follows:

- Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that the Council has the ability to access.
- Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; inputs other than quoted prices that are observable; inputs that are derived principally from or corroborated by observable market data by correlation or other means. If the asset or liability has a specified (contractual) term, the level 2 input must be observable for substantially the full term of the asset or liability.
- Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2013 AND 2012

The asset or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of relevant observable inputs and minimize the use of unobservable inputs.

Following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at June 30, 2013 and 2012.

- **Mutual Funds:** Valued at the daily closing price as reported by the fund. Mutual funds held by the Plan are open-end mutual funds that are registered with the Securities and Exchange Commission. These funds are required to publish their daily net asset value (NAV) and to transact at that price. The mutual funds held by the Council are deemed to be actively traded.

The Council accounts for transfers between the levels within the fair value hierarchy at the end of the reporting period. There were no changes in the valuation methods used during 2013 or 2012, and there were no transfers between classes reported.

All assets measured at fair value on a recurring basis were classified as Level 1 at June 30, 2013 and 2012. Following is a summary. Desegregated information regarding these items is included in Note 2.

	<u>2013</u>	<u>2012</u>
Equity mutual funds	\$ 804,223	\$ 757,937
Fixed income mutual funds	500,396	457,641
	<u>\$ 1,304,619</u>	<u>\$ 1,215,578</u>

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF FINANCIAL POSITION
JUNE 30, 2013

	<u>CSG</u>	<u>Grants</u>	<u>Eliminations</u>	<u>Total</u>
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 8,389,733	\$	\$	\$ 8,389,733
Receivables:				
Grants and contracts		2,358,668		2,358,668
Publications, net	200,241			200,241
Appropriations	126,000			126,000
Interest receivable	55,027			55,027
Due from managed organizations	101,178			101,178
Due from CSG/Grants		(441,359)	441,359	0
Prepaid expenses	209,092			209,092
Total current assets	<u>9,081,271</u>	<u>1,917,309</u>	<u>441,359</u>	<u>11,439,939</u>
Noncurrent assets:				
Investments	18,753,766			18,753,766
Property and equipment, net	688,953			688,953
Total noncurrent assets	<u>19,442,719</u>	<u>0</u>	<u>0</u>	<u>19,442,719</u>
Total assets	<u>\$ 28,523,990</u>	<u>\$ 1,917,309</u>	<u>\$ 441,359</u>	<u>\$ 30,882,658</u>
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,314,447	\$	\$	\$ 1,314,447
Accrued salaries	673,285			673,285
Accrued vacation and sick pay	1,428,784			1,428,784
Due to CSG/Grants	(441,359)		441,359	0
Due to managed organizations	15,176,440			15,176,440
Deferred revenue	740,437	1,917,309		2,657,746
Other accrued expenses	386,239			386,239
Total current liabilities	<u>19,278,273</u>	<u>1,917,309</u>	<u>441,359</u>	<u>21,636,941</u>
Unrestricted net assets:				
Undesignated	8,256,764			8,256,764
Board designated	300,000			300,000
Investment in property and equipment, net	688,953			688,953
Total net assets	<u>9,245,717</u>	<u>0</u>	<u>0</u>	<u>9,245,717</u>
Total liabilities and net assets	<u>\$ 28,523,990</u>	<u>\$ 1,917,309</u>	<u>\$ 441,359</u>	<u>\$ 30,882,658</u>

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF FINANCIAL POSITION
JUNE 30, 2012

	<u>CSG</u>	<u>Grants</u>	<u>Eliminations</u>	<u>Total</u>
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 6,322,560	\$	\$	\$ 6,322,560
Receivables:				
Grants and contracts		3,188,453		3,188,453
Publications, net	179,507			179,507
Appropriations	287,856			287,856
Interest receivable	52,028			52,028
Due from managed organizations	116,928			116,928
Due from CSG/Grants		(1,337,977)	1,337,977	0
Prepaid expenses	247,914			247,914
Total current assets	<u>7,206,793</u>	<u>1,850,476</u>	<u>1,337,977</u>	<u>10,395,246</u>
Noncurrent assets:				
Investments	18,426,016			18,426,016
Property and equipment, net	771,277			771,277
Total noncurrent assets	<u>19,197,293</u>	<u>0</u>	<u>0</u>	<u>19,197,293</u>
Total assets	<u>\$ 26,404,086</u>	<u>\$ 1,850,476</u>	<u>\$ 1,337,977</u>	<u>\$ 29,592,539</u>
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,329,486	\$	\$	\$ 1,329,486
Accrued salaries	706,941			706,941
Accrued vacation and sick pay	1,252,394			1,252,394
Due to CSG/Grants	(1,337,977)		1,337,977	0
Due to managed organizations	15,388,687			15,388,687
Deferred revenue	602,676	1,850,476		2,453,152
Other accrued expenses	571,367			571,367
Total current liabilities	<u>18,513,574</u>	<u>1,850,476</u>	<u>1,337,977</u>	<u>21,702,027</u>
Unrestricted net assets:				
Undesignated	6,819,235			6,819,235
Board designated	300,000			300,000
Investment in property and equipment, net	771,277			771,277
Total net assets	<u>7,890,512</u>	<u>0</u>	<u>0</u>	<u>7,890,512</u>
Total liabilities and net assets	<u>\$ 26,404,086</u>	<u>\$ 1,850,476</u>	<u>\$ 1,337,977</u>	<u>\$ 29,592,539</u>

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF ACTIVITIES
YEAR ENDED JUNE 30, 2013

	<u>CSG</u>	<u>Grants</u>	<u>Eliminations</u>	<u>Total</u>
Revenues:				
Grants and contracts	\$	\$ 15,809,776	\$	\$ 15,809,776
Appropriations and membership dues	6,733,457	21,667		6,755,124
Foundation and project revenue		5,457,025		5,457,025
Contributions	889,223	113,582		1,002,805
Corporate associates	817,000			817,000
Service recovery	566,686		129,599	696,285
Sales of publications	294,732			294,732
Interest and dividends	288,255	53		288,308
Conference center rental	165,093			165,093
Meeting and conference registrations	162,190	1,150		163,340
Net realized and unrealized gains on investments	115,374			115,374
Other	19,224	3,418		22,642
Grantee matching contributions		170,218	(170,218)	0
Total revenues	<u>10,051,234</u>	<u>21,576,889</u>	<u>(40,619)</u>	<u>31,587,504</u>
Expenses:				
Salaries and wages	6,364,309	7,123,303		13,487,612
Employee benefits	2,082,240	1,777,743		3,859,983
Travel and conferences	1,307,646	2,950,628		4,258,274
Consultant and contract services	514,889	4,169,286		4,684,175
Office expenses	687,625	706,633		1,394,258
Rent and property maintenance	605,086	859,747		1,464,833
Contributions to managed organizations	188,188			188,188
Printing and publications	297,027	74,035		371,062
Equipment maintenance	223,967	101,911		325,878
Depreciation	198,036			198,036
	<u>12,469,013</u>	<u>17,763,286</u>	<u>0</u>	<u>30,232,299</u>
Grantee contributions		170,218	(170,218)	0
CSG contribution	(273,207)	273,207		0
Indirect costs recovered:				
Grants	(3,370,178)	3,370,178		0
Allocated	414,522		(414,522)	0
Managed organizations	(544,121)		544,121	0
Total expenses	<u>8,696,029</u>	<u>21,576,889</u>	<u>(40,619)</u>	<u>30,232,299</u>
Change in net assets	1,355,205	\$ <u>0</u>	\$ <u>0</u>	1,355,205
Net assets, beginning of year	<u>7,890,512</u>			<u>7,890,512</u>
Net assets, end of year	<u>\$ 9,245,717</u>			<u>\$ 9,245,717</u>

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF ACTIVITIES
YEAR ENDED JUNE 30, 2012

	<u>CSG</u>	<u>Grants</u>	<u>Eliminations</u>	<u>Total</u>
Revenues:				
Grants and contracts	\$	\$ 13,555,785	\$	\$ 13,555,785
Appropriations and membership dues	6,289,540	15,000		6,304,540
Foundation and project revenue		4,220,285		4,220,285
Contributions	971,472	229,022		1,200,494
Corporate associates	812,000			812,000
Service recovery	364,868		359,883	724,751
Interest and dividends	351,458	1,229		352,687
Sales of publications	264,666			264,666
Meeting and conference registrations	179,375	(325)		179,050
Conference center rental	164,113			164,113
Net realized and unrealized gains on investments	48,387			48,387
Other	77,812	1,074		78,886
Grantee matching contributions		2,500,218	(2,500,218)	0
Total revenues	<u>9,523,691</u>	<u>20,522,288</u>	<u>(2,140,335)</u>	<u>27,905,644</u>
Expenses:				
Salaries and wages	6,484,335	5,323,113		11,807,448
Employee benefits	2,115,823	1,345,504		3,461,327
Travel and conferences	1,404,250	3,119,335		4,523,585
Consultant and contract services	434,932	3,918,523		4,353,455
Office expenses	733,997	624,543		1,358,540
Rent and property maintenance	653,766	640,247		1,294,013
Contributions to managed organizations	241,448			241,448
Printing and publications	286,372	73,710		360,082
Equipment maintenance	258,446	99,544		357,990
Depreciation	199,203			199,203
	<u>12,812,572</u>	<u>15,144,519</u>	<u>0</u>	<u>27,957,091</u>
Grantee contributions		2,500,218	(2,500,218)	0
CSG contribution	(139,268)	139,268		0
Indirect costs recovered:				
Grants	(2,738,283)	2,738,283		0
Allocated	154,897		(154,897)	0
Managed organizations	(514,780)		514,780	0
Total expenses	<u>9,575,138</u>	<u>20,522,288</u>	<u>(2,140,335)</u>	<u>27,957,091</u>
Change in net assets	(51,447)	\$ 0	\$ 0	(51,447)
Net assets, beginning of year	<u>7,941,959</u>			<u>7,941,959</u>
Net assets, end of year	<u>\$ 7,890,512</u>			<u>\$ 7,890,512</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF DUE FROM MANAGED ORGANIZATIONS
JUNE 30, 2013 AND 2012

	<u>2013</u>	<u>2012</u>
National Association of State Treasurers Foundation, Inc.	\$ 96,180	\$ 116,928
Eastern Regional Conference	<u>4,998</u>	<u> </u>
Total due from managed organizations	<u>\$ 101,178</u>	<u>\$ 116,928</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF DUE TO MANAGED ORGANIZATIONS
JUNE 30, 2013 AND 2012

	<u>2013</u>	<u>2012</u>
21st Century Fund	\$ 233,393	\$ 170,061
American Probation and Parole Association	228,533	46,465
American Probation and Parole Association - Restricted Fund	13,829	24,664
American Probation and Parole Association - Services Account	67,407	87,931
Bowhay Institute of Legislative Leadership Development	228,795	246,576
Council of State Governments - West	254,034	303,399
Council of State Governments West Meetings	78,683	66,784
Eastern Regional Conference		59,323
Eastern Trade Council	212,465	182,193
Emergency Management Accreditation Program	712,347	641,325
Interstate Commission for Juveniles	1,311,091	1,208,286
Interstate Commission on Adult Offender Supervision	2,319,707	2,656,603
Interstate Commission on Educational Opportunity for Military Children	743,212	647,994
Legislative Service Agency Directors of Southern Legislative Conference		8,394
Midwest Legislative Conference	749,089	849,391
Midwest Passenger Rail Commission	138,063	111,040
Minds Against Crime	17,966	
National Association of State Facilities Admin. - Eastern Region	3,216	3,203
National Association of State Facilities Admin. - Great Plains	7,788	9,248
National Association of State Facilities Admin. - Southeast Region	4,929	5,178
National Association of State Facilities Admin. - Western Region	8,216	17,350
National Association of State Facilities Administrators	473,670	491,196
National Association of State Personnel Executives, Inc.	397,278	343,275
National Association of State Technology Directors	719,285	718,482
National Association of State Technology Directors - Eastern Region	82,699	69,166
National Association of State Technology Directors - Midwest Region	39,064	38,492
National Association of State Technology Directors - Southern Region	59,655	30,732
National Association of State Technology Directors - Western Region	89,779	61,962
National Association of State Treasurers	844,610	1,011,459
National Association of State Treasurers - College Savings Plan	350,579	350,579
National Association of State Treasurers - State Debt Management Network	83,019	83,019
National Association of State Treasurers - Restricted	595	
National Emergency Management Association	1,339,576	1,303,111
National Hispanic Caucus of State Legislators	1,068,290	794,907
National Hispanic Caucus of State Legislators - Restricted Fund	442,383	149,680
National Lieutenant Governors Association	57,123	1,041,643
Northeast States Association for Agriculture Stewardship	33,075	67,961
Southern Legislative Conference	600,959	524,846
Southern Legislative Conference - Host State Accounts	564,119	474,218
State International Development Organization	241,691	196,362
Western Designated Fund	195,000	160,000
Western Legislative Academy	161,228	132,189
Total due to managed organizations	\$ <u>15,176,440</u>	\$ <u>15,388,687</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
YEAR ENDED JUNE 30, 2013

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
<u>Major Programs:</u>				
<u>U.S. Agency for International Development</u>				
US/Mexico State Alliance Partnership	150-070-70-10552	523-A-00-08-00010-00	\$ 16,900,000	\$ 1,143,481
<u>U.S. Department of Justice</u>				
Bureau of Justice Assistance - Technical Assistance	150-161-70-10673	16.580	375,000	4,920
Improving Law Enforcement	150-161-70-10697	16.580	249,982	12,151
Justice and Mental Health Collaboration Program				
Training and Technical Assistance	150-161-70-11460	16.580	499,441	(348)
Tribal Correctional Options	150-085-70-11465	16.580	400,000	28,999
Improving Criminal Justice Info Sharing	150-161-70-11456	16.580	300,000	34,165
Discovering Corrections Website Project	150-085-70-11594	16.580	400,000	127,239
State-based Capacity Building	150-161-70-11595	16.580	1,562,468	478,154
Supporting Effective Responses	150-161-70-11597	16.580	1,516,405	498,692
Tribal Probation Training	150-085-70-11605	16.580	300,000	91,763
Tribal Probation Academy	150-085-70-11648	16.580	44,829	16,985
National Re-entry Resource Center	150-161-70-11608	16.580	12,388,562	3,411,131
Project Safe Neighborhoods -				
Technology Technical Assistance Program	150-085-70-11717	16.580	200,000	50,642
Tribal Probation Academy - III	150-085-70-11869	16.580	30,000	305
Responses to Those with Mental Illness	150-161-70-10699	16.751	474,978	19,168
Discovering Corrections Website Project	150-085-70-11455	16.751	500,000	38,908
Correction Information Sharing	150-085-70-11587	16.751	1,000,000	139,800
Justice Reinvestment Technology Assistance for States	150-161-70-11598	16.751	7,968,189	2,052,404
Mental Health Curriculum	150-161-70-11599	16.751	1,298,821	334,299
Bringing Network for the Improvement of				
Addiction Treatment to Corrections	150-161-70-11716	16.751	348,691	159,827
Law & Mental Health Data Collection	150-161-70-11596	16.751	428,122	142,510
Public Safety, ARRA	150-161-70-11750	16.803	300,000	224,354
National Re-entry Resource Center	145-161-70-11820	16.812	4,997,895	616,981
			<u>35,583,383</u>	<u>8,483,049</u>

See report of independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
YEAR ENDED JUNE 30, 2013

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
<u>U.S. Department of Homeland Security</u>				
Homeland Technical Assistance Program	415-090-70-11610	97.007	1,800,000	743,046
National Incident Management Systems	415-090-70-11609	97.107	4,000,000	1,725,690
			5,800,000	2,468,736
Total major programs			58,283,383	12,095,266
<u>Nonmajor programs:</u>				
<u>U.S. Department of Defense</u>				
Passed through from U.S. Army Corps of Engineers:				
US Army Corps of Engineering	330-146-70-11453	W91278-09-C-0082	248,090	117,690
<u>U.S. Department of Energy</u>				
Radioactive Waste Transportation Project	10373/10348	81.065	2,625,733	273,486
Radioactive Waste Transportation Project	10369	81.065	(562)	(562)
Radioactive Waste Transportation Project	11792	81.106	300,511	89,389
Radioactive Waste Transportation Project	11850	81.106	110,000	18,058
Radioactive Waste Transportation Project	11856	81.106	30,000	13,501
Radioactive Waste Transportation Project	11793	81.122	425,000	181,050
Radioactive Waste Transportation Project	11794	81.122	375,000	112,002
			3,865,682	686,924
<u>U.S. Department of Health and Human Services</u>				
YR2 Engaging state & local Emergency Management Agency (EMA) to improve states ability	415-090-70-11713	93.069	100,000	29,390
YR3 Engaging state & local EMA to improve states ability	415-090-70-11817	93.069	100,000	91,181
Consulting Contract	150-161-70-11806	HHSS2832007000361	15,000	15,000
National Association of State Emergency Medical Services Officials	150-050-70-11845	HHQDC-12-C-00128	110,409	18,555
Clinical Technical Assistance	145-161-70-11879	HHSS28320070000031	50,000	7,679
			375,409	161,805

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
YEAR ENDED JUNE 30, 2013

<u>Federal Agency</u>	<u>CSG Identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
<u>U.S. Department of Homeland Security</u>				
Emergency Management Assistance Compact - Mutual Aid	415-090-70-11044	97.001	5,100,898	372,323
National Homeland Security Consortium	415-090-70-11720	97.999	23,598	21,343
National Mitigation Alliance	415-090-70-11721	97.999	250,000	131,952
			<u>5,374,432</u>	<u>525,618</u>
<u>U.S. Department of Justice</u>				
Supervision of Partner Abuse	150-085-70-10630	16.008	781,894	77,666
Offender is a Victim - Office on Violence Against Women	150-085-70-11825	16.526	225,000	5,179
Office of Juvenile Justice and Delinquency Prevention Workgroup	150-085-70-11797	16.540	10,000	1,977
Effective School Policies and Practices	150-161-70-11718	16.541	640,000	471,042
Training	150-085-70-11777	16.590	5,000	3,775
Working With Mental Illness	150-161-70-11591	16.601	130,001	(162)
Training Curriculum Development	150-085-70-11821	16.601	90,264	16,929
Intermediate Training on Effective Case Management	150-085-70-11463	16.608	417,802	71,557
Tribal Court	150-085-70-11816	16.608	326,511	21,494
Community Strategic Planning	150-085-70-11859	16.608	60,206	12,195
Project safe neighborhood	150-085-70-11593	16.609	150,000	80,565
Indian Alcohol and Substance Abuse	150-085-70-11647	16.616	44,829	12,189
Re-entry Implementation Guidance	150-161-70-10676	16.710	250,000	7,011
Enhancing Re-entry Initiatives	150-161-70-11741	16.710	10,450	1,966
Citizens Against Physical and Sexual Abuse	150-085-70-11783	16.734	20,000	3,761
Resource Center for the Elimination of Prison Rape	150-085-70-11813	16.735	104,230	45,320
Community Corrections Problem Solving	150-085-70-11435	16.738	669,677	132,903
Corrections Study for the New Hampshire				
Department of Justice	150-161-70-11541	16.738	70,000	39,616
Supporting Effective Responses	145-161-70-11818	16.745	538,195	403,802
State based Capacity Building	145-161-70-11819	16.745	969,318	455,901
Training for Community Corrections, ARRA	150-085-70-11434	16.807	360,791	153,534
Tribal Civil and Criminal Assistance	150-085-70-11815	16.815	489,559	50,063
			<u>6,363,727</u>	<u>2,068,283</u>

See report of Independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
YEAR ENDED JUNE 30, 2013

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
<u>U.S. Department of Transportation</u>				
Driving While Intoxicated Risk Assessment Tools,				
Curriculum and Training	150-085-70-10636	20.216	493,133	103,255
National Highway Traffic Safety Administration Probation Fellow	150-085-70-11429	20.614	435,000	50,935
			<u>928,133</u>	<u>154,190</u>
Total nonmajor programs			<u>17,155,473</u>	<u>3,714,510</u>
Total all programs			<u>\$ 75,438,856</u>	<u>\$ 15,809,776</u>

ARRA - American Recovery and Reinvestment Act

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2013

1. GENERAL

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the Council of State Governments (the Council). The Council's reporting entity is defined in Note 1 to the Council's financial statements. All federal financial assistance was received directly from federal agencies unless specifically noted on the schedule.

The grant revenue amounts received and expensed are subject to audit and adjustment. If any expenditures are disallowed by the grantor as a result of such an audit, any claim for reimbursement to the grantor would become a liability of the Council. In the opinion of management, all grant expenditures are in compliance with the terms of the grant agreements and applicable federal laws and regulations.

2. BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Council and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some of the amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS YEAR ENDED JUNE 30, 2013

3. SUBRECIPIENTS

Of the federal expenditures presented in the schedule, the Council provided federal awards to subrecipients as follows:

Subrecipient	CFDA Number or Other Identifying Number	Amount
Safer Foundation	16.580	312,377
Urban Institute	16.580	149,126
Legal Action Center	16.580	48,150
Center for Employment	16.580	33,466
American Jail Association	16.580	20,438
North Carolina Department of Public Safety	16.751	438,452
University of Wisconsin - Madison	16.751	90,280
New Hampshire Department of Corrections	16.751	72,000
Center for Social Innovation	16.751	45,409
Ohio Department of Rehabilitation	16.751	42,110
National Consortium	16.751	14,441
National Center for State Courts	16.751	12,141
University of North Dakota	16.815	23,496
Iowa Department of Public Health	81.106	59,895
Illinois Emergency Management	93.069	18,025
Illinois Emergency Management	97.107	149,125
Governors Office of Louisiana	97.107	50,000
State of Idaho	97.107	49,793
Arizona Department of Emergency	97.107	30,322
Missouri Office of Homeland Security	97.107	25,907
Arizona Division of Emergency	97.107	20,661
Utah Department of Public Safety	97.107	14,174
State of Michigan Emergency		
Management and Homeland Security	97.107	12,139
Utah Division of Emergency	97.107	11,835
University of Illinois	16.751 & 16.738	57,030
Arizona State University	523-A-00-08-00010-00	161,852
Conference of Western Attorneys General	523-A-00-08-00010-00	140,000
Paso Del Norte Group	523-A-00-08-00010-00	93,078
Woodrow Wilson International Center for Scholars	523-A-00-08-00010-00	88,601
The Borderplex Bi-National Economic Alliance	523-A-00-08-00010-00	55,101
National Lieutenant Governors Association	523-A-00-08-00010-00	36,346
National Association of State Treasurers	523-A-00-08-00010-00	33,288
Iowa Department of Public Health	DE-FC30-07CC00031	89,119
New York State Division of Homeland		
Security and Emergency Services	DE-FC30-07CC00031	63,418
Commonwealth of Pennsylvania	DE-FC30-07CC00031	11,299
Other	Various	136,973
Total federal awards passed through to subrecipients		\$ <u>2,709,867</u>



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**REPORT OF INDEPENDENT AUDITORS ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF
FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT
AUDITING STANDARDS**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of The Council of State Governments (a nonprofit organization, the Council) which comprise the statement of financial position as of June 30, 2013, and the related statements of activities and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated December 5, 2013.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Council's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Council's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Council's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Council's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Blue & Co., LLC

Lexington, Kentucky
December 5, 2013



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REPORT OF INDEPENDENT AUDITORS ON COMPLIANCE FOR EACH MAJOR FEDERAL PROGRAM AND ON INTERNAL CONTROL OVER COMPLIANCE

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Report on Compliance for Each Federal Program

We have audited The Council of State Governments (a nonprofit organization, the Council) compliance with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Council's major federal programs for the year ended June 30, 2013. The Council's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs.

Management's Responsibility

Management is responsible for compliance with the requirements of laws, regulations, contracts, and grants applicable to its federal programs.

Auditor's Responsibility

Our responsibility is to express an opinion on compliance for each of the Council's major federal programs based on our audit of the types of compliance requirements referred to above. We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Council's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances.

We believe that our audit provides a reasonable basis for our opinion on compliance for each major federal program. However, our audit does not provide a legal determination of the Council's compliance.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Opinion on Each Major Federal Program

In our opinion, the Council complied, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2013.

Report on Internal Control Over Compliance

Management of the Council is responsible for establishing and maintaining effective internal control over compliance with the types of requirements referred above. In planning and performing our audit of compliance, we considered the Council's internal control over compliance with the types of requirements that could have a direct and material effect on each major federal program to determine the auditing procedures that are appropriate in the circumstances for the purpose of expressing an opinion on compliance for each major federal program and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement of a federal program on a timely basis. A material weakness in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. A significant deficiency in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over compliance that might be material weaknesses or significant deficiencies. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

The purpose of this report on internal control over compliance is solely to describe the scope of our testing of internal control over compliance and the results of that testing based on the requirements of OMB Circular A-133. Accordingly, this report is not suitable for any other purpose.

Blue & Co., LLC

Lexington, Kentucky
December 5, 2013

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS YEAR ENDED JUNE 30, 2013

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unmodified

Internal Control over financial reporting:

Material weakness(es)
identified? ☐ yes ☒ no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses? ☐ yes ☒ none reported

Noncompliance material to financial
statements noted? ☐ yes ☒ no

Federal Awards

Internal control over major programs:

Material weakness(es)
identified? ☐ yes ☒ no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses? ☐ yes ☒ none reported

Type of auditor's report issued on compliance for major programs: unmodified

Any audit findings disclosed that are
required to be reported in accordance
with section 510(a) of Circular A - 133? ☐ yes ☒ no

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS YEAR ENDED JUNE 30, 2013

The Council's major federal programs for the year ended June 30, 2013 were:

Other Identifying No. 02-523-A-00-08-00010-00

U.S. Agency for International Development - US/Mexico State Alliance Partnership

CFDA No. 16.580:

Edward Byrne Memorial State and Local Law Enforcement Assistance Discretionary Grants Program - See individual grant descriptions on Schedule of Expenditures of Federal Awards.

CFDA No. 16.751:

Edward Byrne Memorial Competitive Grant Program - See individual grant descriptions on Schedule of Expenditures of Federal Awards.

CFDA No. 16.803:

Edward Byrne Memorial Justice Assistance Grant (JAG) Program/ Grants to States and Territories - Public Safety

CFDA No. 16.812:

Second Chance Act Prisoner Reentry Initiative - National Re-entry Resource Center

CFDA No. 97.007:

Homeland Security Preparedness Technical Assistance Program

CFDA No. 97.107:

National Incident Management Systems

The dollar threshold used to distinguish between Type A and Type B programs was \$474,293.

The Council qualified as a low-risk auditee under the provisions of OMB Circular A-133.

Section II - Findings - Financial Statement Audit

None reported.

Section III - Findings and Questioned Costs - Major Federal Awards Program Audit

None reported.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF PRIOR YEAR FINDINGS AND THEIR RESOLUTIONS YEAR ENDED JUNE 30, 2012

No findings or questioned costs were reported for the year ended June 30, 2012.



Sharing capitol ideas.

**THE COUNCIL OF
STATE GOVERNMENTS**

**FINANCIAL STATEMENTS AND
REPORT OF INDEPENDENT AUDITORS**

June 30, 2012 and 2011

THE COUNCIL OF STATE GOVERNMENTS

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REPORT OF INDEPENDENT AUDITORS

To the Governing Board
The Council of State Governments
Lexington, Kentucky

We have audited the accompanying statement of financial position of The Council of State Governments (a nonprofit organization, the Council) as of June 30, 2012 and 2011, and the related statements of activities and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Council's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Council as of June 30, 2012 and 2011 and the results of its operations, its changes in net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 11, 2012 on our consideration of the Council's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Our audits were conducted for the purpose of forming an opinion on the basic financial statements. The supplementary information as listed in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements. The schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic consolidated financial statements or to the basic consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

Blue & Co., LLC

December 11, 2012

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF FINANCIAL POSITION
June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 6,322,560	\$ 6,147,662
Accounts receivable:		
Publications, net of allowance for uncollectible		
accounts of \$20,000 for 2012 and 2011	179,507	254,969
Grants and contracts	3,188,453	1,977,230
Appropriations	287,856	493,113
Interest receivable	52,028	200,533
Due from managed organizations	116,928	48,879
Prepaid expenses	<u>247,914</u>	<u>201,604</u>
Total current assets	<u>10,395,246</u>	<u>9,323,990</u>
Noncurrent assets:		
Investments	18,426,016	17,727,101
Property and equipment, net	<u>771,277</u>	<u>841,629</u>
Total noncurrent assets	<u>19,197,293</u>	<u>18,568,730</u>
Total assets	<u>\$ 29,592,539</u>	<u>\$ 27,892,720</u>
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 1,329,486	\$ 1,296,914
Accrued salaries	706,941	599,200
Accrued vacation and sick pay	1,252,394	1,125,249
Due to managed organizations	15,388,687	13,743,903
Deferred revenue	2,453,152	2,597,637
Other accrued expenses	<u>571,367</u>	<u>587,858</u>
Total current liabilities	<u>21,702,027</u>	<u>19,950,761</u>
Unrestricted net assets:		
Undesignated	6,819,235	6,800,330
Board designated	300,000	300,000
Investment in property and equipment, net	<u>771,277</u>	<u>841,629</u>
Total net assets	<u>7,890,512</u>	<u>7,941,959</u>
Total liabilities and net assets	<u>\$ 29,592,539</u>	<u>\$ 27,892,720</u>

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS
Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Revenues:		
Appropriations and membership dues	\$ 6,304,540	\$ 6,591,290
Grants and contracts	14,325,405	18,102,020
Contributions	4,335,804	4,253,690
Corporate associates	812,000	783,000
Service recovery	724,751	424,235
Sales of publications	264,666	348,193
Meeting / conference registrations	179,050	123,363
Interest and dividends	352,687	378,740
Net realized and unrealized gains on investments	48,387	207,921
Conference center rental	164,113	181,134
Project revenue	315,358	628,182
Other	78,885	140,755
Total revenues	<u>27,905,644</u>	<u>32,162,523</u>
Expenses:		
Salaries and wages	11,807,448	11,012,195
Employee benefits	3,481,327	3,186,181
Travel and conferences	4,523,585	3,691,487
Consultant and contract services	4,353,455	10,466,076
Office expenses	1,358,540	1,184,139
Rent and property maintenance	1,294,013	1,131,996
Contributions to managed organizations	241,448	224,045
Printing and publications	360,082	402,124
Equipment maintenance	357,990	316,188
Depreciation	199,203	218,736
Total expenses	<u>27,957,091</u>	<u>31,833,167</u>
Change in net assets	(51,447)	329,356
Net assets, beginning of year	<u>7,941,959</u>	<u>7,612,603</u>
Net assets, end of year	<u>\$ 7,890,512</u>	<u>\$ 7,941,959</u>

See report of independent auditors and
accompanying notes to the financial statements. 4

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF CASH FLOWS
Years Ended June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
Cash flows from operating activities:		
Change in net assets	\$ (51,447)	\$ 329,356
Adjustments to reconcile change in net assets to net cash flows from operating activities:		
Depreciation	199,203	218,736
Realized and unrealized (gains) on investments	(48,387)	(207,921)
Changes in operating assets and liabilities:		
Accounts receivable - publications	75,462	47,263
Accounts receivable - grants and contracts	(1,211,223)	86,602
Accounts receivable - appropriations	205,257	(431,473)
Interest receivable	148,505	100,472
Prepaid expenses	(46,310)	(53,948)
Accounts payable	32,572	(732,377)
Accrued salaries	107,741	(35,925)
Accrued vacation and sick pay	127,145	71,381
Deferred revenue	(144,485)	(256,584)
Other accrued expenses	(16,491)	173,100
Net cash flows from operating activities	<u>(622,458)</u>	<u>(691,318)</u>
Cash flows from investing activities:		
Proceeds from sales of investments	63,169,144	24,939,548
Purchases of investments	(63,819,672)	(24,851,675)
Change in due from managed organizations	(68,049)	148,007
Purchases of property and equipment	(128,851)	(385,643)
Net cash flows from investing activities	<u>(847,428)</u>	<u>(149,763)</u>
Cash flows from financing activities:		
Change in due to managed organizations	1,644,784	303,334
Change in cash and cash equivalents	174,898	(537,747)
Cash and cash equivalents, beginning of year	<u>6,147,662</u>	<u>6,685,409</u>
Cash and cash equivalents, end of year	<u>\$ 6,322,560</u>	<u>\$ 6,147,662</u>

See report of independent auditors and
accompanying notes to the financial statements. 5

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of The Council of State Governments (the Council) is presented to assist in understanding the Council's financial statements. The financial statements and notes are representations of the Council's management who are responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Description of Organization and Basis of Presentation:

The Council is an unincorporated non-profit, multi-branch organization that serves the states and U.S. territories for the purpose of championing excellence in state government. The Council conducts research on state programs and problems, maintains an information service available to state officials and legislators, issues a variety of publications, acts as a state-federal liaison, promotes regional and state-local cooperation, organizes informative forums and conferences, and provides management services and staff for managed organizations.

The financial statements of the Council have been prepared on the accrual method of accounting. Accordingly, revenues are recognized when they are earned and expenses are recognized when they are incurred.

Governmental grant awards are deemed to be earned and reported as grant revenues when the Council has incurred expenses in compliance with the specific restrictions of the applicable grants. Expenses incurred for which grant funds have not been received are reported as grants receivable, while grant funds received but not yet earned are reported as deferred grant revenue.

Financial Statement Presentation:

The financial statements of the Council have been prepared following the recommendations of Accounting Standards Codification (ASC) 958-205 - *Nonprofit Organization Entities, Presentation of Financial Statements*. Under the provisions set forth therein, net assets, revenues, gains and losses are classified based on the existence or absence of donor-imposed restrictions as follows:

- Unrestricted net assets - Net assets that are not subject to donor-imposed stipulations, and used for various program expenses and general operating functions.
- Temporarily restricted net assets - Net assets subject to donor-imposed stipulations that can be fulfilled by actions of the Council pursuant to those stipulations or that expire by the passage of time.
- Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the Council.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

Use of Estimates:

Management uses estimates and assumptions in preparing the financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and reported revenues and expenses. Actual results could differ from those estimates.

Cash and Cash Equivalents:

For the purposes of the Statements of Cash Flows, the Council considers cash and certificates of deposits with original maturities of three months or less, and corporate commercial paper with original maturities of three months or less to be cash equivalents.

Accounts Receivable:

Accounts receivable includes sales of publications and other receivables. Accounts receivable for sales of publications are stated at unpaid balances less allowance for doubtful accounts. Management estimates an allowance for bad debts based on previous collection experience. Specific accounts are written off when internal collection procedures have ended. Receivables are considered past due based on contractual terms and are recorded at net invoice amounts.

Investments and Investment Income:

Investments are reported at fair value and bear interest at various rates depending on the market. Investments are adjusted to market value at reporting dates, and realized and unrealized gains and losses are recorded in the Statements of Activities and Changes in Net Assets.

Property and Equipment:

Property and equipment acquisitions are stated at cost. Depreciation is provided for using the straight-line method over the estimated useful lives of the respective assets, which range from 2 to 20 years. Acquisitions of property and equipment in excess of \$2,000 are capitalized. The cost of repairs and maintenance is expensed as incurred.

Management Services:

The Council provides management services to certain other organizations including cash management and accounting services. The Council has included the balances due to or due from the Council on the accompanying Statements of Financial Position.

Under the Council's cash management policies, organizations with amounts due to them are paid interest from investment income at a rate of .75% less than the average return earned by the Council on money market funds and long term investments if the managed organization participates in the long-term investment pool.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

Organizations with amounts due from them are charged at a rate of .75% more than the average return earned by the Council on short-term investments. Net interest income allocated to these organizations in 2012 and 2011 was \$137,228 and \$215,464, respectively.

Contributions:

Contributions, including unconditional promises to give, are recognized as revenues in the period received and are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and nature of any donor restrictions. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value. Restricted contributions whose restrictions are satisfied in the period the contributions are received are reported as unrestricted contributions. Restricted net assets are reclassified to unrestricted net assets upon satisfaction of the time or purpose restriction.

The Council did not have any donor-restricted contributions during the years ended June 30, 2012 and 2011.

Compensated Absences:

It is the Council's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. Vacation pay is accrued when earned. Accrued vacation totaling approximately \$1,220,000 and \$1,090,000, respectively, as of June 30, 2012 and 2011 is included in the accompanying Statements of Financial Position.

Accrued sick leave totaling approximately \$33,000 and \$34,000 as of June 30, 2012 and 2011, respectively, relates to sick leave earned prior to June 30, 1995 and represents 20% of the unused sick leave at the current rate of pay. Sick leave earned July 1, 1995 and thereafter is not accrued by the Council.

Deferred Revenue:

Deferred revenue at June 30, 2012 and 2011 consists of appropriations, fees for future meetings, deferred lease amounts, and deferred grant income.

Reclassification:

Certain accounts in the prior year financial statements have been reclassified for comparative purposes to conform to the presentation in the current year.

Subsequent Events:

The Council evaluates events occurring subsequent to the date of the financial statements in determining the accounting for and disclosure of transactions and events that affect the financial statements. Subsequent events have been evaluated through December 11, 2012, which is the date the financial statements were available to be issued.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

2. INVESTMENTS

The composition of investments consisted of the following at June 30:

	<u>2012</u>	<u>2011</u>
Equity mutual funds:		
Large cap	\$ 627,967	\$ 610,941
Medium cap	89,972	81,556
Small cap	39,998	36,577
Fixed income mutual funds:		
U.S. Treasury and Agency	241,076	231,570
U.S. Corporate	193,491	131,519
Other	23,074	48,810
Certificates of deposit	<u>17,210,438</u>	<u>16,586,128</u>
	<u>\$ 18,426,016</u>	<u>\$ 17,727,101</u>

Investments in certificates of deposit (CDs) are carried at cost. Accrued interest on CDs is included in interest receivable on the accompanying financial statements.

CDs are maintained in the Certificate of Deposit Account Registry Service (CDARS). CDARS places funds into certificates of deposit issued by banks within its network in increments less than the Federal Deposit Insurance Corporation (FDIC) insurance limit to ensure that both principal and interest are eligible for full FDIC insurance.

Major classes of assets and liabilities that are measured at fair value are categorized according to a fair value hierarchy that prioritizes the inputs to value techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

Level 1 inputs are readily determinable using unadjusted quoted prices for identical assets or liabilities in active markets. Level 2 inputs are derived from quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (other than those included in Level 1) which are observable for the asset or liability, either directly or indirectly. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. If the inputs used fall within different levels of the hierarchy, the categorization is based upon the lowest level input that is significant to the fair value measurement.

Cost plus accrued interest on the CDs approximates fair value. Investments in equity mutual funds and fixed income mutual funds are carried at fair value based on quoted prices in active markets (Level 1 inputs).

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

3. PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows at June 30:

	2012	2011
Land	\$ 173,337	\$ 173,337
Buildings and improvements	489,468	484,216
Equipment	1,551,861	1,454,047
Automobiles	40,748	40,748
	<u>2,255,414</u>	<u>2,152,348</u>
Less accumulated depreciation	<u>1,484,137</u>	<u>1,310,719</u>
Property and equipment, net	\$ <u>771,277</u>	\$ <u>841,629</u>

4. RETIREMENT PLAN

The Kentucky employees of the Council who work more than one hundred hours per month participate in a defined benefit plan administered by the Kentucky Employees Retirement Systems (KERS) of the Commonwealth of Kentucky, a multiple-employer public employee retirement system. All payroll for the Council employees covered by KERS for the years ended June 30, 2012 and 2011 totaled approximately \$4,945,000 and \$5,140,000, respectively.

Covered employees hired before September 1, 2008 who retire at or after age 65, with 48 months of credited service, are entitled to an annual retirement benefit equal to 1.97% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's average of the five fiscal years during which the employee had the highest average monthly salary.

Benefits fully vest on reaching five years of service. Vested employees may retire after 27 years of service and receive full benefits or retire after age 55 or after 25 years of service and receive reduced retirement benefits. The KERS also provides death and disability benefits. Benefits are established by state statute.

Covered employees hired after September 1, 2008 who retire, at or after age 65 with a minimum of 60 months of credited service or when the employee's age plus their years of service credit equal 87 and they are at least 57 years of age, are entitled to an annual retirement benefit equal to 1.10% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's highest salaried five years. The employee may also be eligible for a reduced retirement benefit at 60 years of age and a minimum of 120 months of credited service. The KERS also provides death and disability benefits. Benefits are established by state statute.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

Covered employees hired before September 1, 2008 are required by state statute to contribute 5.00% of their salaries to the plan. Covered employees hired after September 1, 2008 are required to contribute 5.00% of their salaries to the plan and 1.00% to the KERS Insurance Fund. The Council is required by the same statute to contribute 19.82% and 16.98% of the covered employee's salary for the years ended June 30, 2012 and 2011, respectively. The contribution requirement for the years ended June 30, 2012 and 2011 was approximately \$1,240,000 and \$1,140,000, respectively, which is equal to 100% of the required contributions for each year.

Ten year historical trend information showing the KERS progress in accumulating sufficient assets to pay benefits when due is presented in the KERS Annual Financial Reports (which are a matter of public record). The most recent actuarial valuation was as of June 30, 2011. The Commonwealth of Kentucky's Comprehensive Annual Financial Report should be referred to for additional disclosures related to the KERS.

In addition to the above defined benefit pension plan, a voluntary defined contribution plan is offered to all employees. Employees who participate in TIAA-CREF may contribute either 2% or 5% of their salary into a Tax-Deferred Annuity Plan. Employees who elect to contribute 2% to TIAA-CREF shall receive a matching contribution by the Council of 4%. Employees who elect to contribute 5% to TIAA-CREF shall receive a matching contribution by the Council of 10%. Employees who elect to participate in both KERS and TIAA-CREF will not receive a matching contribution from the Council to their TIAA-CREF Plan when the KERS mandated employer contribution meets or exceeds 10%.

Upon completion of 20 years of service the Council will make an additional 10% contribution for no more than 5 years provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council reserves the right to extend this period for certain employees. The Council reserves the right to make additional Council plan contributions for the Executive Director provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). Total retirement plan expenses amounted to approximately \$805,000 and \$790,000 in 2012 and 2011, respectively.

5. LEASE COMMITMENTS

The Council is obligated under various operating leases for offices and equipment rentals, which expire on various dates through 2022. Rent expense (before recovery from managed organizations) was approximately \$1,300,000 and \$1,170,000 in 2012 and 2011, respectively. Amounts for rent and property maintenance on the accompanying financials are inclusive of recoveries from managed organizations.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

Future gross minimum lease payments (assuming there are no managed organizations sharing in future rent expenses) as of June 30, 2012 are as follows (amounts rounded):

2013	\$	1,330,000
2014		1,230,000
2015		1,250,000
2016		1,250,000
2017		1,090,000
Thereafter		<u>4,570,000</u>
	\$	<u>10,720,000</u>

Rental income associated with subleased office space was approximately \$165,000 and \$180,000 for the years ended June 30, 2012 and 2011, respectively. The future minimum sublease rental revenue for non-cancelable sublease agreements are as follows: year ending 2013, approximately \$140,000.

6. GRANTS AND CONTRACTS

The Council has entered into agreements with various agencies of the United States Government and other organizations. The purpose of the agreements is to perform research and related projects, or assist in defraying expenses for projects undertaken by the Council.

The grants and contracts are subject to various expenditure restrictions and are subject to examination by the granting agency to determine compliance with the related agreements.

Should any expenditure be disallowed, the Council would be required to refund disallowed amounts. For purposes of the accompanying financial statements, a provisional rate for indirect costs has been used as prescribed by the appropriate grantors. The proposal for final indirect cost rate for fiscal year 2012 is currently in process. If the proposal is approved the Council will not be required to refund any material amounts for indirect costs. As such, no provision for refund has been accrued in the accompanying financial statements. The Council has estimated a contingency of approximately \$364,000 if the proposed rate needs to be modified.

Some grants contain provisions which require the Council and its grantees to contribute matching funds or in-kind services to the grant sponsored project. Matching funds were approximately \$2,500,000 and \$855,000 for the years ended June 30, 2012 and 2011, respectively.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS June 30, 2012 and 2011

7. FUNCTIONAL CLASSIFICATION

Expenses by functional classification for the years ended June 30, 2012 and 2011 are as follows:

	2012	2011
Program expenses	\$ 26,041,495	\$ 30,320,014
Support expenses	1,636,910	1,260,336
Fundraising expenses	234,204	252,817
	<u>\$ 27,912,609</u>	<u>\$ 31,833,167</u>

Certain costs have been allocated among the programs and supporting services benefited.

8. CONCENTRATIONS

The Council maintains its cash accounts with federally insured banks primarily in Lexington, Kentucky. The Council maintained approximately \$6,400,000 and \$6,315,000 in an overnight repurchase agreement collateralized by securities at June 30, 2012 and 2011, respectively. Also, see Note 2 regarding investments in CDs. The Council maintained additional amounts in non-interest bearing accounts at June 30, 2012 and 2011, respectively. From December 31, 2010 through December 31, 2012, at all FDIC-insured institutions, deposits held in noninterest-bearing transaction accounts are fully insured regardless of the amount in the account.

Approximately 15% of the accounts receivable is due from one customer as of June 30, 2012. Approximately 36% of the accounts receivable was due from one customer as of June 30, 2011.

For the year ended June 30, 2012, approximately 49% of all revenues were from federal grants. For the year ended June 30, 2011, approximately 57% of all revenues were from federal grants.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2012 and 2011

9. INCOME TAXES

The Council is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code (the Code). However, income from certain activities not directly related to the Council's tax-exempt purpose is subject to taxation as unrelated business income. In addition, the Council has been determined by the Internal Revenue Service not to be a private foundation within the context of Section 509(a) of the Code.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Council and recognize a tax liability if the Council has taken an uncertain position that more likely than not would not be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the Council, and has concluded that as of June 30, 2012 and 2011 there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements. The Council is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

The Council has filed its federal income tax returns for periods through June 30, 2011. These income tax returns are generally open to examination by the relevant taxing authorities for a period of three years from the later of the date the return was filed or its due date (including approved extensions).

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF FINANCIAL POSITION
June 30, 2012

	CSG	Grants	Reconciliation to Statement of Financial Position	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 6,322,560	\$	\$	\$ 6,322,560
Accounts receivable:				
Publications, net	179,507			179,507
Grants and contracts		3,188,453		3,188,453
Appropriations	287,856			287,856
Interest receivable	52,028			52,028
Due from managed organizations	116,928			116,928
Due from CSG/Grants		(1,337,977)	1,337,977	0
Prepaid expenses	247,914			247,914
Total current assets	7,206,793	1,850,476	1,337,977	10,395,246
Noncurrent assets:				
Investments	18,426,016			18,426,016
Property and equipment, net	771,277			771,277
Total noncurrent assets	19,197,293	0	0	19,197,293
Total assets	\$ 26,404,086	\$ 1,850,476	\$ 1,337,977	\$ 29,592,539
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,329,486	\$	\$	\$ 1,329,486
Accrued salaries	706,941			706,941
Accrued vacation and sick pay	1,252,394			1,252,394
Due to CSG/Grants	(1,337,977)		1,337,977	0
Due to managed organizations	15,388,687			15,388,687
Deferred revenue	602,676	1,850,476		2,453,152
Other accrued expenses	571,367			571,367
Total current liabilities	18,513,574	1,850,476	1,337,977	21,702,027
Unrestricted net assets:				
Undesignated	6,819,235			6,819,235
Board designated	300,000			300,000
Investment in property and equipment, net	771,277			771,277
Total net assets	7,890,512	0	0	7,890,512
Total liabilities and net assets	\$ 26,404,086	\$ 1,850,476	\$ 1,337,977	\$ 29,592,539

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF FINANCIAL POSITION
June 30, 2011

	CSG	Grants	Reconciliation to Statement of Financial Position	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 6,147,662	\$	\$	\$ 6,147,662
Accounts receivable:				
Publications, net	254,969			254,969
Grants and contracts		1,977,230		1,977,230
Appropriations	493,113			493,113
Interest receivable	200,533			200,533
Due from managed organizations	48,879			48,879
Due from CSG/Grants		(63,600)	63,600	0
Prepaid expenses	201,604			201,604
Total current assets	7,346,760	1,913,630	63,600	9,323,990
Noncurrent assets:				
Investments	17,727,101			17,727,101
Property and equipment, net	841,629			841,629
Total noncurrent assets	18,568,730	0	0	18,568,730
Total assets	\$ 25,915,490	\$ 1,913,630	\$ 63,600	\$ 27,892,720
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,296,914	\$	\$	\$ 1,296,914
Accrued salaries	599,200			599,200
Accrued vacation and sick pay	1,125,249			1,125,249
Due to CSG/Grants	(63,600)		63,600	0
Due to managed organizations	13,743,903			13,743,903
Deferred revenue	684,007	1,913,630		2,597,637
Other accrued expenses	587,858			587,858
Total current liabilities	17,973,531	1,913,630	63,600	19,950,761
Unrestricted net assets:				
Undesignated	6,800,330			6,800,330
Board designated	300,000			300,000
Investment in property and equipment, net	841,629			841,629
Total net assets	7,941,959	0	0	7,941,959
Total liabilities and net assets	\$ 25,915,490	\$ 1,913,630	\$ 63,600	\$ 27,892,720

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
Year Ended June 30, 2012

	CSG	Grants	Reconciliation to Statement of Activities and Changes in Net Assets	Total
Revenues:				
Appropriations and membership dues	\$ 6,289,540	\$ 15,000	\$	\$ 6,304,540
Grants and contracts		14,325,405		14,325,405
Grantee matching contributions		2,500,218	(2,500,218)	0
Contributions	971,472	3,364,332		4,335,804
Corporate associates	812,000			812,000
Service recovery	364,868		359,683	724,751
Sales of publications	264,666			264,666
Meeting/conference registrations	179,375	(325)		179,050
Interest and dividends	351,458	1,229		352,687
Net realized and unrealized gains on investments	48,387			48,387
Conference center rental	164,113			164,113
Project revenue		315,356		315,356
Other	77,812	1,073		78,885
Total revenues	<u>9,523,691</u>	<u>20,522,288</u>	<u>(2,140,335)</u>	<u>27,905,644</u>
Expenses:				
Salaries and wages	6,484,335	5,323,113		11,807,448
Employee benefits	2,115,823	1,345,504		3,461,327
Travel and conferences	1,404,250	3,119,335		4,523,585
Consultant and contract services	434,932	3,918,523		4,353,455
Office expenses	733,997	624,543		1,358,540
Rent and property maintenance	653,766	640,247		1,294,013
Contributions to managed organizations	241,448			241,448
Printing and publications	286,372	73,710		360,082
Equipment maintenance	258,446	99,544		357,990
Depreciation	199,203			199,203
	<u>12,812,572</u>	<u>15,144,519</u>	<u>0</u>	<u>27,957,091</u>
Grantee contributions		2,500,218	(2,500,218)	0
CSG contribution	(139,268)	139,268		0
Indirect costs recovered:				
Grants	(2,738,283)	2,738,283		0
Allocated	154,897		(154,897)	0
Managed organizations	(514,780)		514,780	0
Total expenses	<u>9,575,138</u>	<u>20,522,288</u>	<u>(2,140,335)</u>	<u>27,957,091</u>
Changes in net assets	(51,447)	\$ 0	\$ 0	(51,447)
Net assets, beginning of year	<u>7,941,959</u>			<u>7,941,959</u>
Net assets, end of year	<u>\$ 7,890,512</u>			<u>\$ 7,890,512</u>

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
Year Ended June 30, 2011

	CSG	Grants	Reconciliation to Statement of Activities and Changes in Net Assets	Total
Revenues:				
Appropriations and membership dues	\$ 6,576,290	\$ 15,000	\$	\$ 6,591,290
Grants and contracts		18,102,020		18,102,020
Grantee matching contributions		852,830	(852,830)	0
Contributions	1,138,262	3,115,428		4,253,690
Corporate associates	783,000			783,000
Service recovery	409,665		14,570	424,235
Sales of publications	348,193			348,193
Meeting/conference registrations	121,563	1,800		123,363
Interest and dividends	372,126	6,614		378,740
Net realized and unrealized gains on investments	207,921			207,921
Conference center rental	181,134			181,134
Project revenue		628,182		628,182
Other	137,699	3,056		140,755
Total revenues	<u>10,275,853</u>	<u>22,724,930</u>	<u>(838,260)</u>	<u>32,162,523</u>
Expenses:				
Salaries and wages	6,392,875	4,619,320		11,012,195
Employee benefits	2,032,522	1,153,659		3,186,181
Travel and conferences	1,301,671	2,389,816		3,691,487
Consultant and contract services	518,808	9,947,268		10,466,076
Office expenses	699,809	484,330		1,184,139
Rent and property maintenance	584,006	547,990		1,131,996
Contributions to managed organizations	224,045			224,045
Printing and publications	304,263	97,861		402,124
Equipment maintenance	253,063	63,125		316,188
Depreciation	218,736			218,736
	<u>12,529,798</u>	<u>19,303,369</u>	<u>0</u>	<u>31,833,167</u>
Grantee contributions		852,830	(852,830)	0
CSG contribution	(102,086)	102,086		0
Indirect costs recovered:				
Grants	(2,466,645)	2,466,645		0
Allocated	353,948		(353,948)	0
Managed organizations	(368,518)		368,518	0
Total expenses	<u>9,946,497</u>	<u>22,724,930</u>	<u>(838,260)</u>	<u>31,833,167</u>
Changes in net assets	329,356	\$ 0	\$ 0	329,356
Net assets, beginning of year	<u>7,612,603</u>			<u>7,612,603</u>
Net assets, end of year	\$ <u>7,941,959</u>			\$ <u>7,941,959</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF DUE FROM MANAGED ORGANIZATIONS
June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
National Association of State Treasurers Foundation, Inc.	\$ <u>116,928</u>	\$ <u>48,879</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF DUE TO MANAGED ORGANIZATIONS
June 30, 2012 and 2011

	<u>2012</u>	<u>2011</u>
21st Century Fund	\$ 170,061	\$ 87,062
Bowhay Institute of Legislative Leadership Development	246,576	230,470
National Lieutenant Governors Association	787,649	642,530
National Lieutenant Governors Association Reserves Fund	231,095	244,142
National Lieutenant Governors Association Restricted Fund	22,899	26,080
Southern Legislative Conference	524,846	419,545
Southern Legislative Conference - Host State Accounts	474,218	760,766
Legislative Service Agency Directors of Southern Legislative Conference	8,394	9,942
Council of State Governments - West	303,399	381,923
Midwest Legislative Conference	849,391	701,714
Western Designated Fund	160,000	160,000
Northeast States Association for Agriculture Stewardship	67,961	62,592
Eastern Regional Conference	59,323	69,078
Eastern Trade Council	182,193	95,986
Council of State Governments West Meetings	66,784	53,564
Midwest Passenger Rail Commission	111,040	90,431
National Emergency Management Association	1,303,111	1,219,962
National Association of State Personnel Executives, Inc.	343,275	323,026
National Association of State Treasurers - College Savings Plan	350,579	350,579
National Association of State Treasurers - State Debt Management Network	83,019	83,019
National Association of State Treasurers	1,011,459	972,703
National Association of State Technology Directors - Western Region	61,962	35,336
National Association of State Technology Directors - Southern Region	30,732	43,719
National Association of State Technology Directors	718,482	767,789
National Association of State Technology Directors - Eastern Region	69,166	47,313
National Association of State Technology Directors - Midwest Region	38,492	36,569
American Probation and Parole Association - Services Account	87,931	38,897
American Probation and Parole Association - Restricted Fund	24,664	42,668
American Probation and Parole Association	46,465	119,966
National Association of State Facilities Admin. - Great Plains	9,248	9,888
National Association of State Facilities Administrators	491,196	493,852
National Association of State Facilities Admin. - Southeast Region	5,178	5,139
National Association of State Facilities Admin. - Western Region	17,350	11,177
National Association of State Facilities Admin. - Eastern Region	3,203	3,180
State International Development Organization	196,362	135,074
National Hispanic Caucus of State Legislators	794,907	611,833
National Hispanic Caucus of State Legislators Restricted Fund	149,680	130,342
National Association of State Chief Administrators	0	177,590
Western Legislative Academy	132,189	136,746
Emergency Management Accreditation Program	641,325	457,911
Interstate Commission on Adult Offender Supervision	2,656,603	2,319,899
Interstate Commission for Juveniles	1,208,286	732,720
Interstate Commission on Educational Opportunity for Military Children	647,994	401,181
Total due to managed organizations	<u>\$ 15,388,687</u>	<u>\$ 13,743,903</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year Ended June 30, 2012

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
<u>Major Programs:</u>				
<u>U.S. Agency for International Development</u>				
US/Mexico State Alliance Partnership	150-070-70-10552	523-A-00-08-00010-00	\$ 15,900,000	\$ 1,516,151
<u>U.S. Department of Energy</u>				
Radioactive Waste Transportation Project	10373/10348	81.065	2,881,133	645,620
Blue Ribbon Commission on America's Nuclear Future	11710	81.065	35,834	35,834
Blue Ribbon Commission on America's Nuclear Future	11714	81.065	19,941	19,941
			<u>2,936,908</u>	<u>701,395</u>
<u>U.S. Department of Justice</u>				
Community Corrections Response to Pandemic Flu	150-085-70-10626	16.580	199,883	(117)
Development of Prison Rape Elimination Act	150-085-70-10621	16.580	256,330	8,176
Supervision Substance Abusing Tribal Offenders	150-085-70-10623	16.580	309,803	(197)
Probation Assessment	150-085-70-10631	16.580	152,853	(425)
Workload Considerations for Effective Public Safety	150-085-70-10633	16.580	188,719	20,780
Bureau of Justice Assistance - Technical Assistance	150-161-70-10673	16.580	375,000	23,105
Justice & Mental Health Collaboration Program Tech	150-161-70-10694	16.580	474,667	(306)
District Level Outreach	150-085-70-10638	16.580	199,464	(536)
Improving Law Enforcement	150-161-70-10697	16.580	249,982	27,012
Creating Better Outcomes	150-161-70-10696	16.580	866,058	(547)
Justice and Mental Health Collaboration Program				
Training and Technical Assistance	150-161-70-11460	16.580	499,960	134,115
Intensive Technical Assistance for Policymakers	150-161-70-11461	16.580	398,671	(1,299)
Tribal Correctional Options	150-085-70-11465	16.580	400,000	55,614
Improving Criminal Justice Info Sharing	150-161-70-11456	16.580	300,000	49,855
Discovering Corrections Website Project	150-085-70-11594	16.580	400,000	167,627
State-based Capacity Building	150-161-70-11595	16.580	1,562,468	572,900
Supporting Effective Responses	150-161-70-11597	16.580	1,516,406	648,134
Tribal Probation Training	150-085-70-11605	16.580	300,000	11,630
Tribal Probation Academy	150-085-70-11648	16.580	44,829	10,261
National Reentry Resource Center	150-161-70-11608	16.580	12,388,562	3,474,943

See report of independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year Ended June 30, 2012

<u>Federal Agency</u>	<u>CSG Identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
Project Safe Neighborhoods - Technology Technical Assistance Program Individualized Education Program Document for Community Corrections	150-085-70-11717	16.580	200,000	3,384
Responses to Those with Mental Illness	150-085-70-10637	16.751	151,839	(161)
Discovering Corrections Website Project	150-161-70-10699	16.751	474,978	22,814
Correction Information Sharing	150-085-70-11455	16.751	500,000	75,845
Justice Reinvestment Technology Assistance for States	150-085-70-11587	16.751	1,000,000	63,856
Mental Health Curriculum, ARRA	150-161-70-11598	16.751	3,473,540	687,460
Bringing Network for the Improvement of Addiction Treatment to Corrections	150-161-70-11599	16.751	1,049,065	372,778
Law & Mental Health Data Collection	150-161-70-11716	16.751	348,691	30,370
	150-161-70-11596	16.751	428,122	108,233
			<u>28,709,889</u>	<u>6,563,304</u>
Total major programs			<u>47,546,797</u>	<u>8,780,850</u>
<u>Nonmajor programs:</u>				
U.S. Department of Transportation				
Driving While Intoxicated Risk Assessment Tools, Curriculum and Training	150-085-70-10636	20.216	493,133	138,922
National Highway Traffic Safety Administration Probation Fellow	150-085-70-11429	20.614	435,000	72,935
			<u>928,133</u>	<u>211,857</u>
U.S. Department of Homeland Security (DOHS)				
Emergency Management Assistance Compact - Mutual Aid	415-090-70-11044	97.001	5,100,896	1,410,072
Preparedness Technical Assistance Program	415-090-70-11451	97.007	215,903	(832)
Preparedness Technical Assistance Program	330-146-70-11458	97.007	1,000,000	217,210
Homeland Technical Assistance Program - Emergency Management Accreditation Program	330-146-70-11610	97.007	1,800,000	535,460
Homeland Technical Assistance Program	415-090-70-11586	97.007	217,626	116,494
Develop Emergency Management Assessment Program	415-090-70-11024	97.107	2,264,926	229,933
National Incident Management Systems	415-090-70-11609	97.107	4,000,000	569,715

See report of independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year Ended June 30, 2012

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
Emergency Management Assistance Compact	415-090-70-11040	97.999	94,184	(20)
National Mitigation Collaborative Alliance White Paper - Federal Emergency Management Agency	415-090-70-11583	97.999	17,996	8,238
National Mitigation Alliance	415-090-70-11720	97.999	23,536	2,194
National Homeland Security Consortium	415-090-70-11721	97.999	250,000	118,048
Education of State Emergency Management Directors	415-090-70-11725	97.999	42,401	42,401
			<u>15,027,468</u>	<u>3,248,913</u>
<u>U.S. Department of Justice (DOJ)</u>				
Supervision of Partner Abuse	150-085-70-10630	16.008	781,894	93,083
BJA FY09 Second Chance Act	150-161-70-11449	16.202	2,195,275	(4,725)
EUDL Judicial & probation Outreach Project with OJJDP	150-085-70-10635	16.541	254,558	11,890
Effective School Policies and Practices	150-161-70-11718	16.541	400,000	163,305
Indicators of Elder Abuse: Distance Learning Tech	150-085-70-10615	16.582	199,755	(245)
Action Partnerships to Enhance Victim Services	150-085-70-11450	16.582	100,000	46,099
Training	150-085-70-11777	16.590	5,000	5
Working With Mental Illness	150-161-70-11591	16.601	130,001	40,207
Intermediate training on Effective Case Management	150-085-70-11463	16.608	417,802	149,982
Tribal Probation Academy Curriculum	150-085-70-11611	16.608	20,908	(166)
Project Safe Neighborhood	150-085-70-11464	16.609	200,000	94,426
Project Safe Neighborhood	150-085-70-11593	16.609	150,000	39,991
Indian Alcohol and Substance Abuse	150-085-70-11647	16.616	44,829	17,745
Reentry Implementation Guidance	150-161-70-10676	16.710	250,000	6,719
Community Abuse Prevention Service Agency	150-085-70-11783	16.734	20,000	936
Community Corrections Problem Solving	150-085-70-11435	16.738	669,677	94,508
Corrections Study for the NH Dept. of Justice	150-161-70-11541	16.738	70,000	16,481
Building State-Based Capacity	150-161-70-11442	16.745	520,204	(4,453)
JMHCP Grantees Technical Assistance	150-161-70-11462	16.745	299,881	(112)
Public Safety (PSTEP), ARRA	150-161-70-11750	16.803	300,000	75,646
Training for Community Corrections	150-085-70-11434	16.807	363,644	145,203
			<u>7,393,428</u>	<u>986,515</u>

See report of Independent auditors and accompanying
notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year Ended June 30, 2012

<u>Federal Agency</u>	<u>CSG identifier</u>	<u>CFDA or other identifying number</u>	<u>Award Amount</u>	<u>Expenses</u>
<u>U.S. Department of Health and Human Services (HHS)</u>				
Engaging State/Local Emergency Management	415-090-70-11585	93.069	98,643	53,474
YR2 Engaging state & local EMA to improve states ability	415-090-70-11713	93.069	100,000	70,610
Engaging State/Local Emergency Management	415-090-70-11042	93.283	503,621	(348)
PS08-813 Initiatives to Educ. St. Officials & Policy Makers	150-050-70-11452	93.977	77,741	613
PS08-813 Initiatives to Educ. St. Officials & Policy Makers	150-050-70-11454	93.977	49,104	(108)
PS08-813 Initiatives to Educ. St. Officials & Policy Makers	150-050-70-11566	93.977	82,500	14,443
SAMHSA/CSAT Tech Assistance	150-161-70-11636	HHSS28320070000031	121,970	105,444
			<u>1,033,579</u>	<u>244,128</u>
Pass-through from U.S. Department of Defense:				
US Army Corp of Engineering	330-146-70-11453	W91278-09-C-0082	248,090	104,600
Total nonmajor programs			<u>24,630,698</u>	<u>4,796,013</u>
Total all programs			<u>\$ 72,177,495</u>	<u>\$ 13,576,863</u>

ARRA - American Recovery and Reinvestment Act

See report of independent auditors and accompanying notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS Year ended June 30, 2012

1. GENERAL

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the Council of State Governments (the Council). The Council's reporting entity is defined in Note 1 to the Council's financial statements. All federal financial assistance was received directly from federal agencies unless specifically noted on the schedule.

The grant revenue amounts received and expensed are subject to audit and adjustment. If any expenditures are disallowed by the grantor as a result of such an audit, any claim for reimbursement to the grantor would become a liability of the Council. In the opinion of management, all grant expenditures are in compliance with the terms of the grant agreements and applicable federal laws and regulations.

2. BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Council and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some of the amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

3. RELATIONSHIP TO FINANCIAL STATEMENTS

Funds restricted by the grantor or other outside party for particular operating purposes are deemed to be earned and reported as revenue when the Council has incurred expenditure in compliance with the specific restrictions.

Federal award expenditures	\$ 13,576,863
Program income	(1,974)
Non-federal portion of grants and contracts	<u>750,516</u>
Revenue - grants and contracts	\$ <u>14,325,405</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS Year ended June 30, 2012

4. SUBRECIPIENTS

Of the federal expenditures presented in the schedule, the Council provided federal awards to subrecipients as follows:

Subrecipient	CFDA Number or Other Identifying Number	Amount
Commonwealth of Pennsylvania	DE-FC30-07CC00031	33,626
Iowa Department of Public Health	DE-FC30-07CC00031	195,938
Illinois Emergency Management	DE-FC30-07CC00031	13,586
Indiana Department of Homeland Security	DE-FC30-07CC00031	44,792
Iowa Department of Public Health	DE-FC30-07CC00031	3,982
Ohio Emergency Management	DE-FC30-07CC00031	44,663
Arizona State University	523-A-00-08-00010-01	80,223
Arizona State University	523-A-00-08-00010-01	91,561
National Association of State Treasurers	523-A-00-08-00010-02	47,390
National Lieutenant Governors Association	523-A-00-08-00010-03	257
Woodrow Wilson International Center for Scholars	523-A-00-08-00010-04	68,587
Woodrow Wilson International Center for Scholars	523-A-00-08-00010-05	45,165
Conference of Western Attorney Generals	523-A-00-08-00010-06	100,000
Paso Del Norte Group	523-A-00-08-00010-07	230,301
Regents of the University of Minnesota	16.008	2,226
Utah Division of Emergency Management	97.107 & 97.001	2,307
Washington Military Department	97.107 & 97.001	887
University of Illinois	16.751 & 16.738	55,392
American Jail Association	16.751	19,531
Center for Innovative Public Policy	16.751	4,224
Fox Valley Technical College	16.608	11,174
Vera Institute of Justice	16.608	13,775
Urban Institute	16.580	323,633
Missouri Office of Homeland Security	97.107	9,866
Kentucky Division of Emergency Management	97.107	16,802
Arizona Department of Emergency Management	97.107	1,161
Utah Division of Emergency Management	97.107	7,054
Washington Military Department	97.107	19,156
West Virginia Division of Homeland Security	97.107	3,028
Police Executive Research Forum	16.751 & 16.738	27,615
Total federal awards passed through to subrecipients		\$ <u>1,517,902</u>



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**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON
COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING
STANDARDS***

To the Governing Board
The Council of State Governments
Lexington, Kentucky

We have audited the financial statements of The Council of State Governments (a nonprofit organization, the Council) as of and for the year ended June 30, 2012, and have issued our report thereon dated December 11, 2012. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Council's internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Council's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management in a separate letter dated December 11, 2012.

This report is intended for the information of the Governing Board, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Blue & Co., LLC

December 11, 2012



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**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH REQUIREMENTS THAT
COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON
INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Compliance

We have audited the compliance of The Council of State Governments (a nonprofit organization, the Council) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Council's major programs for the year ended June 30, 2012. The Council's major federal programs are identified in the Summary of Auditor's Results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Council's management. Our responsibility is to express an opinion on the Council's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Council's compliance with those requirements and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Council's compliance with those requirements.

In our opinion, the Council complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2012.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Internal Control Over Compliance

The management of the Council is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Council's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended for the information of the Governing Board, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Blue & Co., LLC

December 11, 2012

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS Year ended June 30, 2012

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unqualified

Internal Control over financial reporting:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Noncompliance material to financial
statements noted?

_____ yes X no

Federal Awards

Internal control over major programs:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Type of auditor's report issued on compliance for major programs: unqualified

Any audit findings disclosed that are
required to be reported in accordance
with section 510(a) of Circular A-133?

_____ yes X no

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS Year ended June 30, 2012

The Council's major federal programs for the year ended June 30, 2012 were:

Other Identifying No. 02-523-A-00-08-00010-00

U.S. Agency for International Development - US/Mexico State Alliance Partnership

CFDA No. 81.065:

Nuclear Waste Disposal Siting - Radioactive Waste Transportation Project, Blue Ribbon Commission on America's Nuclear Future

CFDA No. 16.580:

Edward Byrne Memorial State and Local Law Enforcement Assistance Discretionary Grants Program - See individual grant descriptions on Schedule of Expenditures of Federal Awards.

CFDA No. 16.751:

Edward Byrne Memorial Competitive Grant Program - See individual grant descriptions on Schedule of Expenditures of Federal Awards.

The dollar threshold used to distinguish between Type A and Type B programs was \$407,306.

The Council qualified as a low-risk auditee under the provisions of OMB Circular A-133.

Section II - Findings - Financial Statement Audit

None reported.

Section III - Findings and Questioned Costs - Major Federal Awards Program Audit

None reported.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF PRIOR YEAR FINDINGS AND THEIR RESOLUTIONS

Year ended June 30, 2011

No findings or questioned costs were reported for the year ended June 30, 2011.

THE COUNCIL OF STATE GOVERNMENTS

**FINANCIAL STATEMENTS AND
REPORT OF INDEPENDENT AUDITORS**

June 30, 2011 and 2010

THE COUNCIL OF STATE GOVERNMENTS

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REPORT OF INDEPENDENT AUDITORS

To the Governing Board
The Council of State Governments
Lexington, Kentucky

We have audited the accompanying statement of financial position of The Council of State Governments (a nonprofit organization, the Council) as of June 30, 2011 and 2010, and the related statements of activities and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Council's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Council as of June 30, 2011 and 2010 and the results of its operations, its changes in net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 2, 2011 on our consideration of the Council's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Our audits were conducted for the purpose of forming an opinion on the basic financial statements. The supplementary information as listed in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements. The schedule of expenditures of federal awards is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the basic financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic financial statements as a whole.

Blue & Co., LLC

November 2, 2011

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF FINANCIAL POSITION
June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
A S S E T S		
Current assets:		
Cash and cash equivalents	\$ 6,147,662	\$ 6,685,409
Accounts receivable:		
Publications, net of allowance for uncollectible		
accounts of \$20,000 for 2011 and 2010	254,969	302,232
Grants and contracts	1,977,230	2,063,832
Appropriations	493,113	61,640
Interest receivable	200,533	301,005
Due from managed organizations	48,879	196,886
Prepaid expenses	201,604	147,656
	<u>9,323,990</u>	<u>9,758,660</u>
Total current assets		
Noncurrent assets:		
Investments	17,727,101	17,607,053
Property and equipment, net	841,629	674,722
	<u>18,568,730</u>	<u>18,281,775</u>
Total noncurrent assets		
Total assets	\$ <u>27,892,720</u>	\$ <u>28,040,435</u>
L I A B I L I T I E S A N D N E T A S S E T S		
Current liabilities:		
Accounts payable	\$ 1,296,914	\$ 2,029,291
Accrued salaries	599,200	635,125
Accrued vacation and sick pay	1,125,249	1,053,868
Due to managed organizations	13,743,903	13,440,569
Deferred revenue	2,597,637	2,854,221
Other accrued expenses	587,858	414,758
	<u>19,950,761</u>	<u>20,427,832</u>
Total current liabilities		
Unrestricted net assets:		
Undesignated	6,800,330	6,637,881
Board designated	300,000	300,000
Investment in property and equipment, net	841,629	674,722
	<u>7,941,959</u>	<u>7,612,603</u>
Total net assets		
Total liabilities and net assets	\$ <u>27,892,720</u>	\$ <u>28,040,435</u>

See accompanying notes to the financial statements. 3

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF ACTIVITIES AND CHANGES IN NET ASSETS
Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Revenues:		
Appropriations and membership dues	\$ 6,591,290	\$ 6,060,203
Grants and contracts	18,102,020	14,942,943
Contributions	4,253,690	3,926,217
Corporate associates	783,000	789,100
Service recovery	424,235	549,055
Sales of publications	348,193	387,071
Meeting / conference registrations	123,363	289,925
Interest and dividends	378,740	379,009
Net realized and unrealized gains on investments	207,921	154,685
Loss on disposal of property and equipment	-0-	(250)
Conference center rental	181,134	190,649
Project revenue	628,182	513,615
Other	140,755	26,557
Total revenues	<u>32,162,523</u>	<u>28,208,779</u>
Expenses:		
Salaries and wages	11,012,195	10,243,539
Employee benefits	3,186,181	2,810,433
Travel and conferences	3,691,487	4,026,329
Consultant and contract services	10,466,076	7,402,307
Office expenses	1,184,139	1,090,402
Rent and property maintenance	1,131,996	1,053,259
Contributions to managed organizations	224,045	487,335
Printing and publications	402,124	418,045
Equipment maintenance	316,188	331,936
Depreciation	218,736	183,004
Total expenses	<u>31,833,167</u>	<u>28,046,589</u>
Change in net assets	329,356	162,190
Net assets, beginning of year	<u>7,612,603</u>	<u>7,450,413</u>
Net assets, end of year	<u>\$ 7,941,959</u>	<u>\$ 7,612,603</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS
STATEMENTS OF CASH FLOWS
Years Ended June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
Cash flows from operating activities:		
Change in net assets	\$ 329,356	\$ 162,190
Adjustments to reconcile change in net assets to net cash flows from operating activities:		
Depreciation	218,736	183,004
Realized and unrealized (gains) on investments	(207,921)	(154,685)
Loss on disposal of property and equipment	-0-	250
Changes in operating assets and liabilities:		
Accounts receivable - publications	47,263	751
Accounts receivable - grants and contracts	86,602	(184,392)
Accounts receivable - appropriations	(431,473)	9,206
Interest receivable	100,472	162,227
Prepaid expenses	(53,948)	(31,081)
Accounts payable	(732,377)	709,038
Accrued salaries	(35,925)	-0-
Accrued vacation and sick pay	71,381	(41,082)
Deferred revenue	(256,584)	(1,505,148)
Other accrued expenses	173,100	(141,746)
Net cash flows from operating activities	<u>(691,318)</u>	<u>(831,468)</u>
Cash flows from investing activities:		
Proceeds from sales of investments	24,939,548	24,285,893
Purchases of investments	(24,851,675)	(22,536,234)
Change in due from managed organizations	148,007	(93,647)
Proceeds from sales of property and equipment	-0-	-0-
Purchases of property and equipment	(385,643)	(100,681)
Net cash flows from investing activities	<u>(149,763)</u>	<u>1,555,331</u>
Cash flows from financing activities:		
Change in due to managed organizations	303,334	1,448,265
Change in cash and cash equivalents	(537,747)	2,172,128
Cash and cash equivalents, beginning of year	<u>6,685,409</u>	<u>4,513,281</u>
Cash and cash equivalents, end of year	<u>\$ 6,147,662</u>	<u>\$ 6,685,409</u>

See accompanying notes
to the financial statements.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

This summary of significant accounting policies of The Council of State Governments (the Council) is presented to assist in understanding the Council's financial statements. The financial statements and notes are representations of the Council's management who is responsible for their integrity and objectivity. These accounting policies conform to accounting principles generally accepted in the United States of America and have been consistently applied in the preparation of the financial statements.

Description of Organization and Basis of Presentation:

The Council is a joint agency of all state governments - created, supported and directed by the individual state governments by an elected board of directors with corresponding regional offices. The Council conducts research on state programs and problems, maintains an information service available to state officials and legislators, issues a variety of publications, acts as a state-federal liaison, promotes regional and state-local cooperation, organizes informative forums and conferences, and provides management services and staff for managed organizations.

The financial statements of the Council have been prepared on the accrual method of accounting. Accordingly, revenues are recognized when they are earned and expenses are recognized when they are incurred.

Governmental grant awards are deemed to be earned and reported as grant revenues when the Council has incurred expenses in compliance with the specific restrictions of the applicable grants. Expenses incurred for which grant funds have not been received are reported as grants receivable, while grant funds received but not yet earned are reported as deferred grant revenue.

Financial Statement Presentation:

The financial statements of the Association have been prepared following the recommendations of Accounting Standards Codification (ASC) 958-205 - *Nonprofit Organization Entities, Presentation of Financial Statements*. Under the provisions set forth therein, net assets, revenues, gains and losses are classified based on the existence or absence of donor-imposed restrictions as follows:

- Unrestricted net assets - Net assets that are not subject to donor-imposed stipulations, and used for various program expenses and general operating functions.
- Temporarily restricted net assets - Net assets subject to donor-imposed stipulations that can be fulfilled by actions of the Council pursuant to those stipulations or that expire by the passage of time.
- Permanently restricted net assets - Net assets subject to donor-imposed stipulations that they be maintained permanently by the Council.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

Use of Estimates:

Management uses estimates and assumptions in preparing the financial statements. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and reported revenues and expenses. Actual results could differ from those estimates.

Cash and Cash Equivalents:

For the purposes of the Statements of Cash Flows, the Council considers cash and certificates of deposits with original maturities of three months or less, and corporate commercial paper with original maturities of three months or less to be cash equivalents.

Accounts Receivable:

Accounts receivable includes sales of publications and other receivables. Accounts receivable for sales of publications are stated at unpaid balances less allowance for doubtful accounts. Management estimates an allowance for bad debts based on previous collection experience. Specific accounts are written off when internal collection procedures have ended. Receivables are considered past due based on contractual terms and are recorded at net invoice amounts.

Investments and Investment Income:

Investments are reported at fair value and bear interest at various rates depending on the market. Investments are adjusted to market value at reporting dates, and realized and unrealized gains and losses are recorded in the Statements of Activities and Changes in Net Assets.

Property and Equipment:

Property and equipment acquisitions are stated at cost. Depreciation is provided for using the straight-line method over the estimated useful lives of the respective assets, which range from 2 to 20 years. Acquisitions of property and equipment in excess of \$2,000 are capitalized. The cost of repairs and maintenance is expensed as incurred.

Management Services:

The Council provides management services to certain other organizations including cash management and accounting services. The Council has included the balances due to or due from the Council on the accompanying Statements of Financial Position.

Under the Council's cash management policies, organizations with amounts due to them are paid interest from investment income at a rate of .75% less than the average return earned by the Council on money market funds and long term investments if the managed organization participates in the long-term investment pool.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

Organizations with amounts due from them are charged at a rate of .75% more than the average return earned by the Council on short-term investments. Net interest income allocated to these organizations in 2011 and 2010 was \$215,464 and \$309,073, respectively.

Contributions:

Contributions, including unconditional promises to give, are recognized as revenues in the period received and are recorded as unrestricted, temporarily restricted, or permanently restricted support depending on the existence and nature of any donor restrictions. Conditional promises to give are not recognized until the conditions on which they depend are substantially met. Contributions of assets other than cash are recorded at their estimated fair value. Restricted contributions whose restrictions are satisfied in the period the contributions are received are reported as unrestricted contributions. Restricted net assets are reclassified to unrestricted net assets upon satisfaction of the time or purpose restriction.

The Council did not have any donor-restricted contributions during the years ended June 30, 2011 and 2010.

Compensated Absences:

It is the Council's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. Vacation pay is accrued when earned. Accrued vacation totaling approximately \$1,091,000 and \$1,017,000, respectively, as of June 30, 2011 and 2010 is included in the accompanying Statements of Financial Position.

Accrued sick leave totaling approximately \$34,000 and \$37,000 as of June 30, 2011 and 2010, respectively, relates to sick leave earned prior to June 30, 1995 and represents 20% of the unused sick leave at the current rate of pay. Sick leave earned July 1, 1995 and thereafter is not accrued by the Council.

Deferred Revenue:

Deferred revenue at June 30, 2011 and 2010 consists of appropriations, fees for future meetings, deferred lease amounts, and deferred grant income.

Reclassification:

Certain 2010 balances were reclassified to conform to the current year presentation.

Subsequent Events:

The Council evaluates events occurring subsequent to the date of the financial statements in determining the accounting for and disclosure of transactions and events that affect the financial statements. Subsequent events have been evaluated through November 2, 2011, which is the date the financial statements were available to be issued.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

2. INVESTMENTS

The composition of investments consisted of the following at June 30:

	<u>2011</u>	<u>2010</u>
Equity mutual funds:		
Large cap	\$ 610,941	\$ 692,532
Medium cap	81,556	121,527
Small cap	36,577	54,503
Fixed income mutual funds:		
U.S. Treasury and Agency	231,158	344,449
U.S. Corporate	131,519	195,977
Foreign	49,222	73,346
Certificates of deposit	<u>16,586,128</u>	<u>16,124,719</u>
	<u>\$ 17,727,101</u>	<u>\$ 17,607,053</u>

Investments in certificates of deposit (CDs) are carried at cost. Accrued interest on CDs is included in interest receivable on the accompanying financial statements.

CDs are maintained in the Certificate of Deposit Account Registry Service (CDARS). CDARS places funds into certificates of deposit issued by banks within its network in increments less than the Federal Deposit Insurance Corporation (FDIC) insurance limit to ensure that both principal and interest are eligible for full FDIC insurance.

Major classes of assets and liabilities that are measured at fair value are categorized according to a fair value hierarchy that prioritizes the inputs to value techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

Level 1 inputs are readily determinable using unadjusted quoted prices for identical assets or liabilities in active markets. Level 2 inputs are derived from quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets (other than those included in Level 1) which are observable for the asset or liability, either directly or indirectly. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. If the inputs used fall within different levels of the hierarchy, the categorization is based upon the lowest level input that is significant to the fair value measurement.

Cost plus accrued interest on the CDs approximates fair value. Investments in equity mutual funds and fixed income mutual funds are carried at fair value based on quoted prices in active markets (Level 1 inputs).

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

3. PROPERTY AND EQUIPMENT

Property and equipment is summarized as follows at June 30:

	2011	2010
Land	\$ 173,337	\$ 173,337
Buildings and improvements	484,216	450,043
Equipment	1,454,047	1,435,159
Automobiles	40,748	40,748
	<u>2,152,348</u>	<u>2,099,287</u>
Less accumulated depreciation	<u>1,310,719</u>	<u>1,424,565</u>
Property and equipment, net	\$ <u>841,629</u>	\$ <u>674,722</u>

4. RETIREMENT PLAN

The Kentucky employees of the Council who work more than one hundred hours per month participate in a defined benefit plan administered by the Kentucky Employees Retirement Systems (KERS) of the Commonwealth of Kentucky, a multiple-employer public employee retirement system. All payroll for the Council employees covered by KERS for the years ended June 30, 2011 and 2010 totaled \$5,140,526 and \$4,794,879, respectively.

Covered employees hired before September 1, 2008 who retire at or after age 65, with 48 months of credited service, are entitled to an annual retirement benefit equal to 1.97% to 2.20% of their final-average salary multiplied by their years of service. Final-average salary is the employee's average of the five fiscal years during which the employee had the highest average monthly salary.

Benefits fully vest on reaching five years of service. Vested employees may retire after 27 years of service and receive full benefits or retire after age 55 or after 25 years of service and receive reduced retirement benefits. The KERS also provides death and disability benefits. Benefits are established by state statute.

Covered employees hired after September 1, 2008 who retire, at or after age 65 with a minimum of 60 months of credited service or when the employee's age plus their years of service credit equal 87 and they are at least 57 years of age, are entitled to an annual retirement benefit equal to 1.10% to 2.00% of their final-average salary multiplied by their years of service. Final-average salary is the employee's highest salaried five years. The employee may also be eligible for a reduced retirement benefit at 60 years of age and a minimum of 120 months of credited service. The KERS also provides death and disability benefits. Benefits are established by state statute.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

Covered employees hired before September 1, 2008 are required by state statute to contribute 5.00% of their salaries to the plan. Covered employees hired after September 1, 2008 are required to contribute 5.00% of their salaries to the plan and 1.00% to the KERS Insurance Fund. The Council is required by the same statute to contribute 16.98% and 11.61% of the covered employee's salary for the years ended June 30, 2011 and 2010, respectively. The contribution requirement for the years ended June 30, 2011 and 2010 was \$1,142,324 and \$804,018, respectively, which is equal to 100% of the required contributions for each year.

Ten year historical trend information showing the KERS progress in accumulating sufficient assets to pay benefits when due is presented in the KERS Annual Financial Reports (which are a matter of public record). The most recent actuarial valuation was as of June 30, 2010. The Commonwealth of Kentucky's Comprehensive Annual Financial Report should be referred to for additional disclosures related to the KERS.

In addition to the above defined benefit pension plan, a voluntary defined contribution plan is offered to all employees. Employees who participate in TIAA-CREF may contribute either 2% or 5% of their salary into a Tax-Deferred Annuity Plan. Employees who elect to contribute 2% to TIAA-CREF shall receive a matching contribution by the Council of 4%. Employees who elect to contribute 5% to TIAA-CREF shall receive a matching contribution by the Council of 10%. Employees who elect to participate in both KERS and TIAA-CREF will not receive a matching contribution from the Council to their TIAA-CREF Plan when the KERS mandated employer contribution meets or exceeds 10%.

Upon completion of 20 years of service the Council will make an additional 10% contribution for no more than 5 years provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Council reserves the right to extend this period for certain employees. The Council reserves the right to make additional Council plan contributions for the Executive Director provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). Total retirement plan expenses amounted to \$791,222 and \$810,625 in 2011 and 2010, respectively.

5. LEASE COMMITMENTS

The Council is obligated under various operating leases for offices and equipment rentals, which expire on various dates through 2022. Rent expense was \$740,372 and \$709,553 in 2011 and 2010, respectively.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

Future gross minimum lease payments (assuming there are no managed organizations sharing in future rent expenses) as of June 30, 2011 are as follows:

2012	\$ 1,029,390
2013	1,075,182
2014	864,568
2015	734,894
2016	727,342
Thereafter	<u>3,067,795</u>
	\$ <u>7,499,171</u>

Rental income associated with subleased office space was \$181,134 and \$190,469 for the years ended June 30, 2011 and 2010, respectively. The future minimum sublease rental revenue for non-cancelable sublease agreements are as follows: year ending 2012, \$141,465.

6. GRANTS AND CONTRACTS

The Council has entered into agreements with various agencies of the United States Government and other organizations. The purpose of the agreements is to perform research and related projects, or assist in defraying expenses for projects undertaken by the Council.

The grants and contracts are subject to various expenditure restrictions and are subject to examination by the granting agency to determine compliance with the related agreements.

Should any expenditure be disallowed, the Council could be required to refund disallowed amounts. A provision has been made for indirect costs applied for reimbursement that were in excess of actual amounts. No other provision has been made for possible disallowed costs in the accompanying financial statements, as management is of the opinion that controls are in place that adequately monitor expenditure restriction compliance.

Some grants contain provisions which require the Council and its grantees to contribute matching funds or in-kind services to the grant sponsored project. Matching funds were \$852,830 and \$45,012 for the years ended June 30, 2011 and 2010, respectively.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

7. FUNCTIONAL CLASSIFICATION

Expenses by functional classification for the years ended June 30, 2011 and 2010 are as follows:

	<u>2011</u>	<u>2010</u>
Program expenses	\$ 30,320,014	\$ 26,465,535
Support expenses	1,260,336	1,349,400
Fundraising expenses	<u>252,817</u>	<u>231,654</u>
	<u>\$ 31,833,167</u>	<u>\$ 28,046,589</u>

8. CONCENTRATIONS

The Council maintains its cash accounts with federally insured banks primarily in Lexington, Kentucky. Occasionally, the accounts are above the federally insured limit. The Council considers the risks associated with its excess cash balances to be minimal. Approximately \$0 and \$66,000 was maintained in various bank accounts in excess of the federally insured limit at June 30, 2011 and 2010, respectively. The Council maintained \$6,315,000 and \$6,509,000 in an overnight repurchase agreement collateralized by securities at June 30, 2011 and 2010, respectively. Also, see Note 2 regarding investments in CDs.

Approximately 36% of the accounts receivable is due from one customer as of June 30, 2011. Approximately 37% of the accounts receivable was due from one customer as of June 30, 2010.

For the year ended June 30, 2011, approximately 57% of all revenues were from federal grants. For the year ended June 30, 2010, approximately 45% of all revenues were from federal grants.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE FINANCIAL STATEMENTS

June 30, 2011 and 2010

9. INCOME TAXES

The Council is organized as a not-for-profit corporation under Section 501(c)(3) of the United States Internal Revenue Code. However, the Council is subject to income taxes on certain unrelated business income. During 2011 and 2010, no income taxes were paid by the Council. The Council's Internal Revenue Service (IRS) Form 990 (Returns of Organizations Exempt from Income Tax) for 2008, 2009, and 2010 are subject to examination by the IRS, generally for three years after they are filed.

Accounting principles generally accepted in the United States of America require management to evaluate tax positions taken by the Council and recognize a tax liability if the Council has taken an uncertain position that more likely than not would be sustained upon examination by various federal and state taxing authorities. Management has analyzed the tax positions taken by the Council, and has concluded that as of June 30, 2011 and 2010, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the accompanying financial statements. The Council is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress.

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF FINANCIAL POSITION
June 30, 2011

	CSG	Grants	Reconciliation to Statement of Financial Position	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 6,147,662	\$	\$	\$ 6,147,662
Accounts receivable:				
Publications, net	254,969			254,969
Grants and contracts		1,977,230		1,977,230
Appropriations	493,113			493,113
Interest receivable	200,533			200,533
Due from managed organizations	48,879			48,879
Due from CSG/Grants		(63,600)	63,600	-0-
Prepaid expenses	201,604			201,604
Total current assets	7,346,760	1,913,630	63,600	9,323,990
Noncurrent assets:				
Investments	17,727,101			17,727,101
Property and equipment, net	841,629			841,629
Total noncurrent assets	18,568,730	-0-	-0-	18,568,730
Total assets	\$ 25,915,490	\$ 1,913,630	\$ 63,600	\$ 27,892,720
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 1,296,914	\$	\$	\$ 1,296,914
Accrued salaries	599,200			599,200
Accrued vacation and sick pay	1,125,249			1,125,249
Due to CSG/Grants	(63,600)		63,600	-0-
Due to managed organizations	13,743,903			13,743,903
Deferred revenue	684,007	1,913,630		2,597,637
Other accrued expenses	587,858			587,858
Total current liabilities	17,973,531	1,913,630	63,600	19,950,761
Unrestricted net assets:				
Undesignated	6,800,330			6,800,330
Board designated	300,000			300,000
Investment in property and equipment, net	841,629			841,629
Total net assets	7,941,959	-0-	-0-	7,941,959
Total liabilities and net assets	\$ 25,915,490	\$ 1,913,630	\$ 63,600	\$ 27,892,720

See report of independent
auditors on pages 1 and 2.

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF FINANCIAL POSITION
June 30, 2010

	CSG	Grants	Reconciliation to Statement of Financial Position	Total
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 6,685,409	\$	\$	\$ 6,685,409
Accounts receivable:				
Publications, net	302,232			302,232
Grants and contracts		2,063,832		2,063,832
Appropriations	61,640			61,640
Interest receivable	301,005			301,005
Due from managed organizations	196,886			196,886
Due from CSG/Grants		(157,486)	157,486	-0-
Prepaid expenses	147,656			147,656
Total current assets	7,694,828	1,906,346	157,486	9,758,660
Noncurrent assets:				
Investments	17,607,053			17,607,053
Property and equipment, net	674,722			674,722
Total noncurrent assets	18,281,775	-0-	-0-	18,281,775
Total assets	\$ 25,976,603	\$ 1,906,346	\$ 157,486	\$ 28,040,435
LIABILITIES AND NET ASSETS				
Current liabilities:				
Accounts payable	\$ 2,029,291	\$	\$	\$ 2,029,291
Accrued salaries	635,125			635,125
Accrued vacation and sick pay	1,053,868			1,053,868
Due to CSG/Grants	(157,486)		157,486	-0-
Due to managed organizations	13,440,569			13,440,569
Deferred revenue	947,875	1,906,346		2,854,221
Other accrued expenses	414,758			414,758
Total current liabilities	18,364,000	1,906,346	157,486	20,427,832
Unrestricted net assets:				
Undesignated	6,637,881			6,637,881
Board designated	300,000			300,000
Investment in property and equipment, net	674,722			674,722
Total net assets	7,612,603	-0-	-0-	7,612,603
Total liabilities and net assets	\$ 25,976,603	\$ 1,906,346	\$ 157,486	\$ 28,040,435

See report of independent
auditors on pages 1 and 2.

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
Year Ended June 30, 2011

	CSG	Grants	Reconciliation to Statement of Activities and Changes in Net Assets	Total
Revenues:				
Appropriations and membership dues	\$ 6,576,290	\$ 15,000	\$	\$ 6,591,290
Grants and contracts		18,102,020		18,102,020
Grantee matching contributions		852,830	(852,830)	-0-
Contributions	1,138,262	3,115,428		4,253,690
Corporate associates	783,000			783,000
Service recovery	409,665		14,570	424,235
Sales of publications	348,193			348,193
Meeting/conference registrations	121,563	1,800		123,363
Interest and dividends	372,126	6,614		378,740
Net realized and unrealized gains on investments	207,921			207,921
Conference center rental	181,134			181,134
Project revenue		628,182		628,182
Other	137,699	3,056		140,755
Total revenues	<u>10,275,853</u>	<u>22,724,930</u>	<u>(838,260)</u>	<u>32,162,523</u>
Expenses:				
Salaries and wages	6,392,875	4,619,320		11,012,195
Employee benefits	2,032,522	1,153,659		3,186,181
Travel and conferences	1,301,671	2,389,816		3,691,487
Consultant and contract services	518,808	9,947,268		10,466,076
Office expenses	699,809	484,330		1,184,139
Rent and property maintenance	584,006	547,990		1,131,996
Contributions to managed organizations	224,045			224,045
Printing and publications	304,263	97,861		402,124
Equipment maintenance	253,063	63,125		316,188
Depreciation	218,736			218,736
	<u>12,529,798</u>	<u>19,303,369</u>	<u>-0-</u>	<u>31,833,167</u>
Grantee contributions		852,830	(852,830)	-0-
CSG contribution	(102,086)	102,086		-0-
Indirect costs recovered:				
Grants	(2,466,645)	2,466,645		-0-
Allocated	353,948		(353,948)	-0-
Managed organizations	(368,518)		368,518	-0-
Total expenses	<u>9,946,497</u>	<u>22,724,930</u>	<u>(838,260)</u>	<u>31,833,167</u>
Changes in net assets	329,356	\$ -0-	\$ -0-	329,356
Net assets, beginning of year	<u>7,612,603</u>			<u>7,612,603</u>
Net assets, end of year	<u>\$ 7,941,959</u>			<u>\$ 7,941,959</u>

See report of independent
auditors on pages 1 and 2.

THE COUNCIL OF STATE GOVERNMENTS
COMBINING STATEMENT OF ACTIVITIES AND CHANGES IN NET ASSETS
Year Ended June 30, 2010

	CSG	Grants	Reconciliation to Statement of Activities and Changes in Net Assets	Total
Revenues:				
Appropriations and membership dues	\$ 6,045,203	\$ 15,000	\$	\$ 6,060,203
Grants and contracts		14,942,943		14,942,943
Grantee matching contributions		45,012	(45,012)	-0-
Contributions	1,084,652	2,841,565		3,926,217
Corporate associates	789,100			789,100
Service recovery	448,856		100,199	549,055
Sales of publications	387,071			387,071
Meeting/conference registrations	289,275	650		289,925
Interest and dividends	364,627	14,382		379,009
Net realized and unrealized gains on investments	154,685			154,685
Loss on sale of property and equipment	(250)			(250)
Conference center rental	190,649			190,649
Project revenue		513,615		513,615
Other	25,057	1,500		26,557
Total revenues	<u>9,778,925</u>	<u>18,374,667</u>	<u>55,187</u>	<u>28,208,779</u>
Expenses:				
Salaries and wages	6,131,733	4,111,806		10,243,539
Employee benefits	1,814,225	996,208		2,810,433
Travel and conferences	1,426,671	2,599,658		4,026,329
Consultant and contract services	384,029	7,018,278		7,402,307
Office expenses	643,925	446,477		1,090,402
Rent and property maintenance	518,678	534,581		1,053,259
Contributions to managed organizations	487,335			487,335
Printing and publications	317,089	100,956		418,045
Equipment maintenance	276,362	55,574		331,936
Depreciation	183,004			183,004
	<u>12,183,051</u>	<u>15,863,538</u>	<u>-0-</u>	<u>28,046,589</u>
Grantee contributions		45,012	(45,012)	-0-
CSG contribution	(237,789)	237,789		-0-
Indirect costs recovered:				
Grants	(2,228,328)	2,228,328		-0-
Allocated	325,391		(325,391)	-0-
Managed organizations	(425,590)		425,590	-0-
Total expenses	<u>9,616,735</u>	<u>18,374,667</u>	<u>55,187</u>	<u>28,046,589</u>
Changes in net assets	162,190	\$ <u>-0-</u>	\$ <u>-0-</u>	162,190
Net assets, beginning of year	<u>7,450,413</u>			<u>7,450,413</u>
Net assets, end of year	<u>\$ 7,612,603</u>			<u>\$ 7,612,603</u>

See report of independent
auditors on pages 1 and 2.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF DUE FROM MANAGED ORGANIZATIONS
June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
National Association of State Treasurers Foundation, Inc.	\$ 48,879	\$ 70,806
National Association of State Treasurers - Midwest	-0-	10,981
Southern Governors Association	-0-	346
American Probation and Parole Association	-0-	39,731
National Association of Unclaimed Property Administrators	<u>-0-</u>	<u>75,022</u>
Total due from managed organizations	<u>\$ 48,879</u>	<u>\$ 196,886</u>

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF DUE TO MANAGED ORGANIZATIONS
June 30, 2011 and 2010

	<u>2011</u>	<u>2010</u>
21st Century Fund	\$ 87,062	\$ 209,299
Bowhay Institute of Legislative Leadership Development	230,470	250,766
National Lieutenant Governors Association	642,530	421,654
National Lieutenant Governors Association Reserves Fund	244,142	237,873
National Lieutenant Governors Association Restricted Fund	26,080	25,913
Midwest Governors Association	-0-	736,598
Southern Legislative Conference	419,545	518,050
Southern Legislative Conference - Host State Accounts	760,766	974,494
Legislative Service Agency Directors of Southern Legislative Conference	9,942	5,633
Council of State Governments - West	381,923	306,411
Midwest Legislative Conference	701,714	606,052
Western Designated Fund	160,000	130,000
Northeast States Association for Agriculture Stewardship	62,592	53,119
Eastern Regional Conference	69,078	73,445
Eastern Trade Council	95,986	11,497
CSG West Meetings	53,564	60,290
Midwest Passenger Rail Commission	90,431	61,219
National Emergency Management Association	1,219,962	1,052,536
National Association of State Personnel Executives, Inc.	323,026	262,696
National Association of State Treasurers - Northeast	-0-	3,854
National Association of State Treasurers - College Savings Plan	350,579	367,419
National Association of State Treasurers - State Debt Management Network	83,019	93,058
National Association of State Treasurers	972,703	696,330
National Association of State Technology Directors - Western	35,336	51,330
National Association of State Technology Directors - Southern	43,719	23,429
National Association of State Treasurers - Southern	-0-	15,342
National Association of State Technology Directors	767,789	845,976
National Association of State Technology Directors - Eastern	47,313	33,039
National Association of State Technology Directors - Midwest	36,569	43,675
American Probation and Parole Association - Services Account	38,897	39,336
American Probation and Parole Association Restricted Fund	42,668	38,434
American Probation and Parole Association	119,966	-0-
National Association of State Facilities Admin. - Great Plains	9,888	12,404
National Association of State Facilities Administrators	493,852	475,676
National Association of State Facilities Admin. - Southeast Region	5,139	6,174
National Association of State Facilities Admin. - Western Region	11,177	12,642
National Association of State Facilities Admin. - Eastern Region	3,180	3,758
State International Development Organization	135,074	86,471
National Hispanic Caucus of State Legislators	611,833	817,127
National Hispanic Caucus of State Legislators Restricted Fund	130,342	81,087
National Association of State Chief Administrators	177,590	236,114
Western Legislative Academy	136,746	194,340
Emergency Management Accreditation Program	457,911	363,832
Interstate Commission on Adult Offender Supervision	2,319,899	2,155,927
Interstate Commission for Juveniles	732,720	490,506
Interstate Commission on Educational Opportunity for Military Children	401,181	255,742
Total due to managed organizations	<u>\$ 13,743,903</u>	<u>\$ 13,440,569</u>

See report of independent
auditors on pages 1 and 2.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year Ended June 30, 2011

<u>MAJOR PROGRAMS</u>	<u>FEDERAL AGENCY</u>	<u>CFDA NUMBER OR OTHER IDENTIFYING NUMBER</u>	<u>AWARD AMOUNT</u>	<u>FY 2011 EXPENSES</u>
<u>U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT</u>				
US/Mexico State Alliance Partnership		02-523A000800001000	\$ 14,400,000	\$ 8,425,836
<u>U.S. Department of Justice</u>				
Bureau of Justice Assistance FY09 Second Chance Act		16-202	2,200,000	852,111
Juvenile Justice and Mental Health Program Grantees Technical Assistance		16-745	299,993	14,018
Building State-based Capacity		16-745	524,557	432,274
Intensive Technical Assistance for Policymakers		16-580	399,970	137,231
Discovering Corrections Website Project		16-580	400,000	17,115
Community Corrections Response to Pandemic Flu		16-580	200,000	14,774
State Based Capacity Building		16-580	823,721	463,500
Development of Prison Rape Elimination Act (PREA)		16-580	257,178	100,503
Supervision Substance Abusing Tribal Offenders		16-580	310,000	25,049
Supporting Effective Responses		16-580	720,000	329,627
Tribal Probation Training		16-580	300,000	9,686
American University		16-580	1,014	1,014
Probation Assessment		16-580	153,278	32,434
Tribal Probation Academy		16-580	44,829	4,745
Tribal Correctional Options		16-580	400,000	65,883
Workload Considerations for Effective Public Safety		16-580	189,000	14,613
National Reentry Resource Center		16-580	4,549,988	1,841,531
Improving Criminal Justice Info Sharing		16-580	300,000	44,892
Bureau of Justice Assistance - Technical Assistance		16-580	375,000	70,287
Justice and Mental Health Collaboration Program Training and Technical Assistance		16-580	499,960	247,555
Justice and Mental Health Collaboration Program Technical Assistance		16-580	474,973	39,799
District Level Outreach		16-580	200,000	68,044
Improving Law Enforcement		16-580	249,982	41,011
Creating Better Outcomes		16-580	866,605	65,513
Total major programs			14,740,148	4,933,209
			29,140,148	13,359,045

See notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
Year Ended June 30, 2011

<u>FEDERAL AGENCY</u>	<u>CFDA NUMBER OR OTHER IDENTIFYING NUMBER</u>	<u>AWARD AMOUNT</u>	<u>FY 2011 EXPENSES</u>
<u>NONMAJOR PROGRAMS</u>			
<u>U.S. Department of Transportation</u>			
Driving While Intoxicated Risk Assessment Tools, Curriculum and Training	20-216	493,133	122,241
National Highway Traffic Safety Administration Probation Fellow	20-614	435,000	65,649
		<u>928,133</u>	<u>187,890</u>
<u>U.S. Department of Energy (DOE)</u>			
Radioactive Waste Transportation Project	81-065	2,131,262	529,860
Solar Energy	81-117	40,140	3,931
		<u>2,171,402</u>	<u>533,791</u>
<u>U.S. Department of Homeland Security (DOHS)</u>			
Develop Emergency Management Assessment Program	97-107	2,274,997	197,151
National Incident Management Systems	97-107	4,000,000	17,046
Emergency Management Assessment Compact - Mutual Aid	97-001	5,100,896	1,205,750
Homeland Technical Assistance Program - Emergency Management Program	97-007	1,800,000	27,488
Homeland Technical Assistance Program	97-007	250,000	101,132
Preparedness Technical Assistance Program	97-007	216,735	105,676
Preparedness Technical Assistance Program	97-007	1,000,000	511,790
National Mitigation Collaborative Alliance White Paper - Federal Emergency Management Agency		19,980	9,757
Emergency Management Assistance Compact - Mutual Aid	97 HSFEHO-10-P-1056	1,036,160	2,570
		<u>15,698,768</u>	<u>2,178,360</u>
<u>U.S. Department of Justice (DOJ)</u>			
Supervision of Partner Abuse	16-008	781,894	94,875
EUOL Judicial and Probation Outreach Project with OJJDP	16-541	267,949	54,194
Indicators of Elder Abuse: Distance Learning Tech	16-582	200,000	31,174
Action Partnerships to Enhance Victim Services	16-582	100,000	34,814
Working With Mental Illness	16-601	130,001	89,794
Tribal Probation Academy Curriculum	16-608	21,074	21,075
Intermediate Training on Effective Case Management	16-608	417,802	62,946
Project Safe Neighborhoods	16-609	200,000	91,861
Project Safe Neighborhoods	16-609	150,000	12,852
Indian Alcohol and Substance Abuse	16-616	44,829	531
Re-entry Implementation Guidance	16-710	250,000	14,873
Community Corrections Problem Solving	16-738	669,677	89,353
Corrections Study for the NH Department of Justice	16-738	70,000	6,959

See notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Year Ended June 30, 2011

<u>FEDERAL AGENCY</u>	<u>CFDA NUMBER OR OTHER IDENTIFYING NUMBER</u>	<u>AWARD AMOUNT</u>	<u>FY 2011 EXPENSES</u>
Individualized Education Program Document for Community Corrections Responses to those with Mental Illness	16-751	152,000	20,420
Discovering Corrections Website Project	16-751	474,978	90,717
Correction Information Sharing	16-751	400,000	193,009
Law & Mental Health Data Collection	16-751	1,000,000	70,937
Justice Reinvestment Technical Assistance for States	16-751/16-738	428,122	125,852
Mental Health Curriculum - American Recovery and Reinvestment Act	16-751	2,249,969	398,505
Training for Community Corrections	16-807	649,971	110,684
		363,644	34,865
		<u>9,021,910</u>	<u>1,652,470</u>
<u>U.S. Department of Health and Human Services (HHS)</u>			
Engaging State/Local Emergency Management	93-089	100,000	45,169
Engaging State/Local Emergency Management	93-283	503,969	52,388
Initiatives to Educate State Officials and Policymakers	93-977	82,500	31,434
Initiatives to Educate State Officials and Policymakers	93-977	49,212	13,835
Substance Abuse and Mental Health Services/Center for Substance Abuse Treatment	93-977	82,500	54,147
Tech Assistance			
	93.HHSS2832007000031	41,252	17,426
		<u>859,433</u>	<u>214,399</u>
Pass-through from U.S. Department of Defense:			
U.S. Army Corp of Engineering	W91278-09-C-0082	117,282	115,135
Pass-through U.S. Department of Justice:			
Identifying Mental Health Policy Issues	6674S00158	49,981	2,343
		<u>28,646,909</u>	<u>4,884,388</u>
Total nonmajor programs		<u>\$ 57,987,057</u>	<u>\$ 18,243,433</u>

See notes to the schedule of expenditures of federal awards.

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS Year ended June 30, 2011

1. GENERAL

The accompanying Schedule of Expenditures of Federal Awards presents the activity of all federal financial assistance programs of the Council of State Governments (the Council). The Council's reporting entity is defined in Note 1 to the Council's financial statements. All federal financial assistance was received directly from federal agencies unless specifically noted on the schedule.

The grant revenue amounts received and expensed are subject to audit and adjustment. If any expenditures are disallowed by the grantor as a result of such an audit, any claim for reimbursement to the grantor would become a liability of the Council. In the opinion of management, all grant expenditures are in compliance with the terms of the grant agreements and applicable federal laws and regulations.

2. BASIS OF PRESENTATION

The accompanying Schedule of Expenditures of Federal Awards includes the federal grant activity of the Council and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some of the amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the basic financial statements.

3. RELATIONSHIP TO FINANCIAL STATEMENTS

Funds restricted by the grantor or other outside party for particular operating purposes are deemed to be earned and reported as revenue when the Council has incurred expenditure in compliance with the specific restrictions.

Federal award expenditures	\$ 18,243,433
Less program income	4,455
Non-federal portion of grants and contracts	<u>(136,958)</u>
Revenue - grants and contracts	\$ <u>18,102,020</u>

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS Year ended June 30, 2011

4. SUBRECIPIENTS

Of the federal expenditures presented in the schedule, the Council provided federal awards to subrecipients as follows:

Subrecipient	CFDA Number or Other Identifying Number	Amount Provided to Subrecipient
Center for Addictions Research and Evaluation	20-216	\$ 9,900
Commonwealth of Pennsylvania	81-065	704
Iowa Department of Public Health	81-065	99,880
Illinois Emergency Management Agency	81-065	20,333
Indiana Department of Homeland Security	81-065	441
Ohio Department of Public Safety	81-065	21,804
Council of Western Attorney Generals	02-523A0008000100	6,600,840
Paso Del Norte	02-523A00080001000	840,447
Woodrow Wilson International Center for Scholars	02-523A0008000100	23,313
San Diego State University	02-523A00080001000	7,000
Borders Consulting	02-523A00080001000	24,781
CDC Software	02-523A00080001000	5,005
Arizona State University	02-523A00080001000	118,240
National LT Governors Association	02-523A00080001000	9,025
Crime & Justice Institute	16-202	18,500
National Association of State Correctional Administrators	16-202	12,833
American Indian Development Association	16-202	3,387
Center for Employment Opportunities	16-202	31,333
Health Care For the Homeless, Inc.	16-602	1,500
Urban Institute	16-602	119,343
Johns Hopkins University	16-602	30,160
National Association of Counties Research Foundation	16-602	19,250
Hungrything, LLC	16-602	20,220
Shay Bilchik Consulting, LLC	16-202	12,375
Policy Research Associates	16-202	5,000
Safer Foundation	16-202	47,000
Advocates for Youth & Family Behavioral	16-580	281
Pretrial Justice Institute	16-580	1,700
CARES, LLC	16-580	2,306
Policy Research Associates	16-580	35,235

THE COUNCIL OF STATE GOVERNMENTS

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS Year ended June 30, 2011

John Hopkins University	16-580	33,977
Fund for the City of New York Center	16-580	3,810
CASES	16-580	2,925
Crime & Justice Institute	16-850	22,752
Hungrything, LLC	16-850	16,480
GP+A, Inc.	16-580	5,000
Community Corrections Institute	16-580	3,600
National Association of Counties		
Research Foundation	16-580	6,014
Northpointe Institute for Public Management	16-580	6,000
Shay Bilchik Consulting, LLC	16-580	12,313
Urban Institute	16-580	119,995
Vera Institute of Justice	16-580	4,781
Center for Effective Public Policy	16-580	6,146
Hungrything, LLC	16-580	1,800
Tribal Law & Policy Institute	16-580	2,700
Public Policy Solutions	16-745	900
Emergix	97-007	4,800
New York State Coalition Against		
Domestic Violence, Inc.	16-008	18,101
Regents of the University of		
Minnesota	16-008	1,639
Innoweb Designs	93-283	3,600
Essential Learning	16-751	16,167
University of Illinois	16-751	4,977
American Correctional Association	16-751	20,631
Fund for the City of New York	16-751	2,970
National Center for State Courts	16-751	3,758
Center for Innovative Public Policies	16-751	2,813
American Jail Association	16-751	27,007
Police Executive Research Forum	16-751	50,688
National Judicial College	16-751	5,993
Emergix	97-107	3,600
South Carolina Emergency		
Management	97-107	9,837
Oklahoma Emergency Management	97-107	18,772
State of Louisiana	97-107	10,000
IEM, Inc.	97-107	91,102
Fox Valley Technical College	16-608	12,440
Vera Institute of Justice	16-608	6,108
Total federal awards passed		
through to subrecipients		\$ <u>8,706,332</u>

We have audited the financial statements of The Council of State Governments (a nonprofit organization, the Council) as of and for the year ended June 30, 2011, and have issued our report thereon dated November 2, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

In planning and performing our audit, we considered the Council's internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Council's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over financial reporting.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Council's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management in a separate letter dated November 2, 2011.

This report is intended for the information of the Governing Board, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Blue & Co., LLC

November 2, 2011



MEMPHIS, TENNESSEE 38103-1100
www.bluememphis.com

**INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH REQUIREMENTS THAT
COULD HAVE A DIRECT AND MATERIAL EFFECT ON EACH MAJOR PROGRAM AND ON
INTERNAL CONTROL OVER
COMPLIANCE IN ACCORDANCE WITH OMB CIRCULAR A-133**

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Compliance

We have audited the compliance of The Council of State Governments (a nonprofit organization, the Council) with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Council's major programs for the year ended June 30, 2011. The Council's major federal programs are identified in the Summary of Auditor's Results section of the accompanying Schedule of Findings and Questioned Costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the Council's management. Our responsibility is to express an opinion on the Council's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the Council's compliance with those requirements and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination on the Council's compliance with those requirements.

In our opinion, the Council complied, in all material respects, with the compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended June 30, 2011.

To the Governing Board
The Council of State Governments
Lexington, Kentucky

Internal Control Over Compliance

The management of the Council is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the Council's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Council's internal control over compliance.

A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance with a type of compliance requirement of a federal program on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended for the information of the Governing Board, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Blue & Co., LLC

November 2, 2011

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS Year ended June 30, 2011

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unqualified

Internal Control over financial reporting:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Noncompliance material to financial
statements noted?

_____ yes X no

Federal Awards

Internal control over major programs:

Material weakness(es)
identified?

_____ yes X no

Significant deficiency(s)
identified that are not
considered to be
material weaknesses?

_____ yes X none reported

Type of auditor's report issued on compliance for major programs: unqualified

Any audit findings disclosed that are
required to be reported in accordance
with section 510(a) of Circular A-133?

_____ yes X no

The Council's major federal programs for the year ended June 30, 2011 were:

Other Identifying No. 02-523A00080001000
US/Mexico State Alliance Partnership

CFDA No. 16-580:

Development of Prison Rape Elimination Act, Intensive Technical Assistance for Policymakers, Justice and Mental Health Collaboration Program Training and Technical Assistance, Justice and Mental Health Collaboration Program Technical Assistance, Creating Better Outcomes, Supervision Substance Abuse Tribal Offenders, Improving Criminal Justice Information Sharing, Probation Assessment, Community Corrections Response to Pandemic Flu, Tribal Corrections

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

Year ended June 30, 2011

Bureau of Justice Assistance Technical Assistance, District Level Outreach, Discovering Corrections Website Project, State Based Capacity Building, Supporting Effective Responses, Tribal Probation Training, American University, Tribal Probation Academy, and National Reentry Resource Center

CFDA No. 16-202:

Bureau of Justice Assistance FY09 Second Chance Act

CFDA No. 16-745:

Juvenile Justice and Mental Health Program Grantees Technical Assistance and Building State-based Capacity

The dollar threshold used to distinguish between Type A and Type B programs was \$547,303.

The Council qualified as a low-risk auditee under the provisions of OMB Circular A-133.

Section II - Findings - Financial Statement Audit

None

Section III - Findings and Questioned Costs - Major Federal Awards Program Audit

None

THE COUNCIL OF STATE GOVERNMENTS

SCHEDULE OF PRIOR YEAR FINDINGS AND THEIR RESOLUTIONS Year ended June 30, 2010

No findings or questioned costs were reported for the year ended June 30, 2010.

Attachment 11

Documentation of the alternative retirement program created by CSG for its employees.

**The Council of State Governments
Defined Contribution Retirement Plan**

401A Plan Document

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Article I: Definitions

- 1.1 **Accumulation Account** means the separate account(s) established for each Participant. The current value of a Participant's Accumulation Account includes all Plan Contributions, less expense charges, and reflects credited investment experience.
- 1.2 **Annual Additions** means the sum of the following amounts credited to a Participant's Accumulation Account during the Limitation Year: (a) Plan Contributions; (b) forfeitures, if any; and (c) individual medical account amounts described in section 415(1)(2) and 419A(d)(2) of the Code, if any.
- 1.3 **Beneficiary(ies)** means the individual, institution, trustee, or estate designated by the Participant to receive the Participant's benefits at his or her death.
- 1.4 **Board** means the Institution's Governing Board.
- 1.5 **Break in Service** means a 12-consecutive month period (computation period) during which the Participant does not complete more than 500 Hours of Service with the Institution. For determining whether a Break in Service has occurred in a computation period, an individual who is absent from work for maternity or paternity reasons will receive credit for the Hours of Service that would otherwise have been credited to the individual but for his or her absence, or in any case in which the hours cannot be determined, 8 Hours of Service per day for the absence. For this paragraph, an absence from work for maternity or paternity reasons means an absence (a) because of the pregnancy of the individual, (b) because of a birth of a child of the individual, (c) because of the placement of a child with the individual in connection with the adoption of the child by the individual, or (d) for purposes of caring for the child for a period beginning immediately following birth or placement. The Hours of Service credited under this paragraph will be credited (a) in the computation period in which the absence begins if the crediting is necessary to prevent a Break in Service in that period, or (b) in all other cases, in the following computation period. The total number of Hours of Service credited shall not exceed 501 hours.
- 1.6 **Code** means the Internal Revenue Code of 1986, as amended.
- 1.7 **Compensation** means the amount paid by the Institution to a Participant that must be reported as wages on the Participant's Form W-2 plus compensation that is not currently includable in the Participant's gross income because of the application of I.R.C. § 125, 132(f)(4), 457(b) or 403(b) through a salary reduction agreement.

In addition to other applicable limitations stated in the Plan, and notwithstanding any other provision of the Plan to the contrary, for Plan years beginning on or after January 1, 1996, the annual compensation of each employee taken into account under the Plan shall not exceed the OBRA '93 annual compensation limit. The OBRA '93 annual compensation limit is \$150,000, as adjusted by the Commissioner of the Internal Revenue Service for increases in the cost of living in accordance with section 401(a)(17)(B) of the Internal Revenue Code. The Plan will automatically adjust to be in compliance with the current annual compensation limit set by the I.R.C. § 401(a)(17)(B). The cost-of-living adjustment in effect for a calendar year applies to any period, not exceeding 12 months, over which compensation is determined (determination period) beginning in such calendar year. If a determination period consists of fewer than 12 months, the OBRA '93 annual compensation limit will be multiplied by a fraction, the numerator of which is the number of months in the determination period, and the denominator of which is 12.

For plan years beginning on or after January 1, 1996, any reference in this Plan to the limitation under section 401(a)(17) of the Internal Revenue Code shall mean the OBRA '93 annual compensation limit stated in this provision.

If compensation for any prior determination period is taken into account in determining an employee's

benefits accruing in the current Plan Year, the compensation for that prior determination period is subject to the OBRA '93 annual compensation limit in effect for that prior determination period. For this purpose, for determination periods beginning before the first day of the first Plan Year beginning on or after January 1, 1996, the OBRA '93 annual compensation limit is \$150,000.

Notwithstanding the above, employees who became participants in the Plan before the first day of the Plan Year beginning on or after January 1, 1996, will not be subject to the annual compensation limit.

- 1.8 ***Date of Employment or Reemployment*** means the effective date of the appointment for a faculty member. For all other employees, the Date of Employment or Reemployment is the first day upon which an employee completes an Hour of Service for performance of duties during the employee's most recent period of service with the Institution.

- 1.9 ***Eligible Employee*** means all regular employees who work at least 20 hours per week.

The term Eligible Employee shall not include any leased employee deemed to be an employee of the Institution as provided in Code Section 414(n).

No individual who is deemed to be an independent contractor, as determined by the Plan Administrator in its sole discretion, or individual performing services for the Employer pursuant to an agreement that provides that such individual shall not be eligible to participate in the retirement or other benefit plans of the Employer, shall be an Eligible Employee for purposes of this plan.

If an individual is classified as an independent contractor during any period of providing services to the Institution, such individual will be deemed to be in an ineligible class of employees for purposes of the Plan during such period, even if the individual is determined to be a common law employee during such period pursuant to a government audit or litigation. Notwithstanding the above, if the failure to cover such reclassified individual would prevent the Plan from satisfying the minimum coverage requirement under Code Section 410(b) for a Plan year, the minimum number of such individuals necessary for the plan to fulfill such minimum coverage requirements will be included as eligible employees for the plan year, with preference given to those reclassified individuals with the smallest amount of compensation.

- 1.10 ***Eligible Employer*** means any educational organization.

- 1.11 ***Fund Sponsor*** means insurance, variable annuity or investment company that provides Funding Vehicles available to Participants under this Plan.

- 1.12 ***Funding Vehicles*** means the annuity contracts or custodial accounts that satisfy the requirements of Code Section 401(f) issued for funding accrued benefits under this Plan and specifically approved by the Institution for use under this Plan.

- 1.13 ***Hours of Service*** means:

- (a) Each hour for which an employee is paid, or entitled to payment, for the performance of duties for the Institution.
- (b) Each hour for which an employee is paid, or entitled to payment, on account of a period of time during which no duties are performed (regardless of whether employment has terminated) due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty, leave of absence, or maternity or paternity leave (whether paid or unpaid). However, any period for which a payment is made or due under a plan maintained solely for the purpose of complying with Workers' Compensation or unemployment compensation or disability insurance laws, or solely to reimburse the employee for medical or medically-related expenses is excluded. An employee is directly or indirectly paid, or entitled to payment by the Institution regardless of whether payment is made by or due from the Institution directly or made indirectly through a trust fund, insurer or other entity to which the Institution contributes or pays premium. No more than 501 Hours of Service will be

credited under this paragraph. Hours of Service under this paragraph will be calculated and credited pursuant to Section 2530.200b-2 of the Department of Labor Regulations, incorporated herein by reference.

- (c) Each hour for which back pay, irrespective of mitigation of damages, is either awarded or agreed to by the Institution, without duplication of hours provided above, and subject to the 501-hour restriction for periods described in (b) above.

Hours of Service will be credited for employment with other members of an affiliated service group (under Code Section 414(m)), a controlled group of corporations (under Code Section 414(b)), or a group of trades or businesses under common control (under Code Section 414(c)) of which the Institution is a member, and any other entity required to be aggregated with the employer pursuant to Code Section 414(o) and the regulations thereunder. Hours of Service also will be credited for any person considered an employee for this Plan under Code Sections 414(n) or 414(o) and the regulations thereunder.

Hours of Service will be determined on the basis of actual hours that an employee is paid or entitled to payment.

- 1.14 *Institution* means The Council of State Governments.
- 1.15 *Institution Plan Contributions* means contributions made by the Institution under this Plan.
- 1.16 *Limitation Year* means a calendar year.
- 1.17 *Normal Retirement Age* means age 65.
- 1.18 *Participant* means any Eligible Employee of the Institution participating in this Plan.
- 1.19 *Participant Plan Contributions* means contributions made by a Participant under this Plan.
- 1.20 *Plan* means the Institution's Defined Contribution Retirement Plan as set forth in this document.
- 1.21 *Plan Contributions* means contributions made under this Plan by the Institution and Participant.
- 1.22 *Plan Entry Date* means the first of the month beginning after the date that the employee has met the participation requirements set forth in Article III.
- 1.23 *Plan Year* means January 1 through December 31.
- 1.24 *Year of Service* means a 12-month period (computation period) during which the Eligible Employee completes 1,000 or more Hours of Service. For purposes of eligibility for participation, Year(s) of Service with an Eligible Employer during the period immediately preceding the Eligible Employee's Date of Employment with the Institution will be counted.

Article II: Establishment of Plan

- 2.1 *Establishment of Plan.* The Board of The Council of State Governments (the 'Institution') established the Plan as of October 1, 1945.

This plan document sets forth the provisions of this Code Section 401(a)-Qualified Plan. The Plan was restated as of December 1, 2003. Plan Contributions are invested, at the direction of each Participant, in one or more of the Funding Vehicles available to Participants under the Plan. Plan Contributions shall be held for the exclusive benefit of Participants.

Article III: Eligibility for Participation

- 3.1 **Eligibility.** An Eligible Employee may, on a voluntary basis begin participation in this Plan on the Plan Entry Date following fulfillment of the following requirement(s):

- The completion of 6 months of Service at the Institution.
- Participants in this Plan may make TDA Contributions of either 2% or 5% of Compensation under The Council of State Governments Tax-Deferred Annuity Retirement Plan. Plan Contributions will only be made for Participants contributing to The Council of State Governments Tax-Deferred Annuity Retirement Plan.

Year(s) of Service with an Eligible Employer will be counted for meeting the eligibility requirements.

- 3.2 **Notification.** The Institution will notify an Eligible Employee when he or she has completed the requirements necessary to become a Participant. An Eligible Employee who complies with the requirements and becomes a Participant is entitled to the benefits and is bound by all the terms, provisions, and conditions of this Plan, including any amendments that, from time to time, may be adopted, and including the terms, provisions and conditions of any Funding Vehicle(s) to which Plan Contributions for the Participant have been applied.

- 3.3 **Enrollment in Plan.** To participate in this Plan, an Eligible Employee must complete the necessary enrollment form(s) and return them to the Institution. An employee who has been notified that he or she is eligible to participate but who fails to return the enrollment forms will be deemed to have waived all of his or her rights under the Plan except the right to enroll at a future date.

- 3.4 **Re-employment.**

- (a) A former Participant will become a Participant immediately upon returning to the employ of the Institution if the former Participant had a non-forfeitable right to all or a portion of the Accumulation Account derived from the Institution Plan Contributions at the time of termination from service and the former Participant is an Eligible Employee.
- (b) A former Participant who did not have a non-forfeitable right to any portion of the Accumulation Account derived from the Institution Plan Contributions at the time of termination from service will be considered a new employee for eligibility purposes, if the number of consecutive one-year Breaks in Service equals or exceeds five. If the Years of Service before termination from service cannot be disregarded pursuant to the preceding sentence, the former Participant will participate immediately upon reemployment provided the former Participant is an Eligible Employee.

- 3.5 **Termination of Participation.** A Participant will continue to be eligible for the Plan until one of the following conditions occur:

- you stop contributing to the Plan;
- he or she ceases to be an Eligible Employee;
- the Plan is terminated.

- 3.6 **Computation Period.** For purposes of determining Year of Service for purposes of eligibility for participation, the initial computation period is the 12-consecutive month period beginning with the day the employee first performs an Hour of Service. Any subsequent computation period will begin on the anniversary of the day the employee first performed an Hour of Service.

Article IV: Plan Contributions

- 4.1 **Plan Contributions.** Plan Contributions will be made for Eligible Employees who have satisfied the requirements of Article III in accordance with the schedule below. Institution Plan Contributions will only be made for Participants who are making the required Participant Plan Contribution.

Institution Plan Contributions will only be made for Participants making the minimum contribution to the Institution's Tax-Deferred Annuity (TDA) Plan.

Plan Contributions as a Percentage of Compensation

Employees hired in Kentucky beginning work on or after December 1, 2003, shall participate in KERS and may participate in TIAA-CREF. Employees who participate in TIAA-CREF may contribute either 2% or 5% of their salary into a Tax-Deferred Annuity Plan. Employees who elect to contribute 2% to the TIAA-CREF Tax-Deferred Annuity Plan shall be matched by an Institution Plan Contribution of 4%. Employees who elect to contribute 5% to the TIAA-CREF Tax-Deferred Annuity Plan shall be matched by an Institution Plan Contribution of 10%. Employees who elect to participate in both KERS and TIAA-CREF will not receive an Institution Plan Contribution to their TIAA-CREF Plan when the KERS mandated employer contribution meets or exceeds 10%.

Or

Employees hired outside Kentucky may participate in TIAA-CREF by contributing either 2% or 5% of their salary into a Tax-Deferred Annuity Plan. Employees who elect to contribute 2% to the TIAA-CREF Tax-Deferred Annuity Plan shall be matched by an Institution Plan Contribution of 4%. Employees who elect to contribute 5% to the TIAA-CREF Tax-Deferred Annuity Plan shall be matched by an Institution Plan Contribution of 10%.

Upon Completion of 20 years of service the Institution will make an additional 10% Institution Plan Contribution for no more than 5 years provided the amount does not exceed the limits imposed by I.R.C. §415 and 403(b). The Institution reserves the right to extend this period for certain employees.

The Institution reserves the right to make additional Institutional Plan Contributions for the Executive Director provided the amount does not exceed the limits imposed by I.R.C. § 415 and 403(b).

Plan Contributions are considered to be credited to Participants no later than the last day of the Plan Year for which the Plan Contributions are made.

- 4.2 **When Contributions Are Made.** Plan Contributions will begin when the Institution has determined that the Participant has met or will meet the requirements of Article III. Any part of a year's Plan Contributions not contributed before this determination will be included in contributions made for that year after the determination. Plan Contributions will be forwarded to the Funding Vehicle(s) in accordance with the procedures established by the Institution. Institution Plan Contributions will be forwarded to the Funding Vehicles at least annually. Participant Plan Contributions will be forwarded by the Institution to the Fund Sponsor as soon as it is administratively feasible for the Institution to segregate contributions, but in any event, within the time required by law.
- 4.3 **Allocation of Contributions.** A Participant may allocate Plan Contributions to the Funding Vehicle(s) in any whole-number percentages that equal 100 percent. A Participant may change his or her allocation of future contributions to the Funding Vehicle(s) at any time.
- 4.4 **Leave of Absence.** During a paid leave of absence, Plan Contributions will continue to be made for a Participant on the basis of Compensation then being paid by the Institution. No Plan Contributions will be made during an unpaid leave of absence.

- 4.5 **Transfer of Funds from Another Plan.** The Fund Sponsor shall accept contributions that are transferred directly from any other plan qualified under sections 401(a) or 403(a) of the Code, whether such plans are funded through a trustee arrangement or through an annuity contract, if such contributions are attributable only to employer and employee contributions and the earnings thereon and accompanied by instructions showing the respective amounts attributable to employer and employee contributions. Such funds and the accumulation generated from them shall always be fully vested and non-forfeitable of the Code, whether such plans are funded through a trustee arrangement or through an annuity contract, if such contributions are attributable only to employer and employee contributions and the earnings thereon and accompanied by instructions showing the respective amounts attributable to employer and employee contributions. Such funds and the accumulation generated from them shall always be fully vested and non-forfeitable.
- 4.6 **Acceptance of Rollover Contributions.** If a Participant is entitled to receive a distribution from another plan qualified under sections 401(a) or 403(a) of the Code that is an eligible rollover distribution under section 402 of the Code, the Fund Sponsor will accept such amount under this Plan provided the rollover to this Plan is made 1) directly from another plan; or 2) by the Participant within 60 days of the receipt of the distribution..
- 4.7 **Uniformed Services.** Notwithstanding any provision of this Plan to the contrary, contributions, benefits, and service credit with respect to qualified military service will be provided in accordance with §414(u) of the Code.
- 4.8 **Maximum Plan Contributions.** Notwithstanding anything contained in this Plan to the contrary, the total Annual Additions made for any Participant for any year will not exceed the amount permitted under section 415 of the Code. The limitations of Code Section 415 are hereby incorporated by reference.

For the purpose of calculating the limits of Code Section 415, compensation means a Participant's earned income, wages, salaries, and fees for professional services and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan and excluding the following: (a) employer contributions to a plan of deferred compensation that are not includible in the employee's gross income for the taxable year in which contributed, or employer contributions under a simplified employee pension plan to the extent such contributions are deductible by the employee, or any distributions from a plan of deferred compensation; and (b) other amount that received special tax benefits, or contributions made by the employer (whether or not under a salary reduction agreement towards the purchase of an annuity described in Code Section 403(b) (whether or not the amounts are actually excludable from the gross income of the employee)). For years beginning after December 31, 1997, compensation shall include any elective deferral (as defined in Code Section 402(g)(3)) and any amount which is contributed or deferred by the Institution at the election of the Participant and which is not includible in the gross income of the Participant by reason of Code Section 125, 132(f)(4) or 457.

To the extent permitted by Code Section 415 and the regulations promulgated thereunder, if the Annual Additions exceed the Section 415 limitations, the excess amounts will be disposed of as follows: (a) any Participant Plan Contributions (plus any gain attributable to the excess), to the extent they would reduce the excess amount, will be returned to the Participant; and, to the extent necessary, (b) if, after the application of (a) an excess still exists, the excess will be held unallocated in a suspense account and will be applied to reduce Institution Plan Contributions in succeeding limitation years.

If the limitations are exceeded because the Participant is also participating in another Plan required to be aggregated with this Plan for Code Section 415, then the extent to which annual contributions under this Plan will be reduced, as compared with the extent to which annual benefits or contributions under any other plans will be reduced, will be determined by the Institution in a manner as to maximize the aggregate benefits payable to the Participant from all plans. If the reduction is under this Plan, the Institution will advise affected Participants of any additional limitation on their annual contributions required by this paragraph.

Article V: Funding Vehicles

5.1 **Funding Vehicles.** Plan Contributions are invested in one or more Funding Vehicles available to Participants under this Plan. The Fund Sponsors and their Funding Vehicles are:

A. Teachers Insurance and Annuity Association (TIAA)

TIAA Retirement Annuity (RA)

Traditional Annuity
Real Estate Account

B. College Retirement Equities Fund (CREF)

CREF Retirement Unit-Annuity (RA)

Stock Account
Money Market Account
Bond Market Account
Social Choice Account
Global Equities Account
Growth Account
Equity Index Account
Inflation-Linked Bond Account

The Institution's current selection of Fund Sponsors and Funding Vehicles isn't intended to limit future additions or deletions of Fund Sponsors and Funding Vehicles. Any additional accounts offered by a Fund Sponsor will automatically be made available to Participants in accordance with the procedures established by the Institution and the Fund Sponsor.

5.2 **Fund Transfers.** Subject to a Funding Vehicle's rules for transfers and in accordance with the provisions of the Code for maintaining the tax deferral of the Accumulation Account(s), a Participant may transfer funds accumulated under the Plan among the Plan's approved Funding Vehicles to the extent permitted by the Funding Vehicles.

Article VI: Vesting

- 6.1 **Plan Contributions.** Institution Plan Contributions shall be non-forfeitable and fully vested in the Participant in accordance with the following vesting schedule:

Completed Years of Service	Vested Percentage	Forfeitable Percentage
1st Year	20%	80%
2nd Year	40%	60%
3rd Year	60%	40%
4th Year	80%	20%
5th Year	100%	0%

Years of Service with an Eligible Employer will be counted for purposes of determining the Years of Service at the Institution for vesting purposes.

Notwithstanding the above vesting schedule, Institution Plan Contributions shall be non-forfeitable and fully vested at Normal Retirement Age, death or disability, if earlier. In addition, any Qualified Non-elective Contributions as defined in 401(m) of the Code are fully and immediately vested when made.

If employment terminates before the date of full vesting, the contracts or certificates issued to the Institution for a Participant are returned to the Fund Sponsors and amended to provide for a transfer of ownership in the vested amount of the Accumulation Account(s), if any, to the Participant. The non-vested amount of the Accumulation Account(s) will constitute a forfeiture that will be applied to reduce Institution Plan Contributions for the next Plan Year.

- 6.2 **Termination of Service; Reinstatement.** If a Participant in this Plan terminates before full vesting in the Institution Plan Contributions, the Participant's pre-break and post-break service will be counted for vesting of the pre-break and post-break Institution-derived Accumulation only if the Participant is re-employed before the number of consecutive one-year Breaks in Service equals five years.

In the case of a Participant who has five or more consecutive one-year Breaks in Service, post-break Years of Service will be disregarded for vesting of the pre-break Institution-derived Accumulation. However, both pre-break and post-break service will be counted for vesting the Institution-derived account that accumulates subsequent to reemployment.

- 6.3 **Computation Period for Vesting.** For purposes of determining Years of Service and Breaks in Service, the computation period shall be measured by the Participant's Date of Employment or Reemployment and each anniversary thereof.

- 6.4 **Amendment to Vesting Schedule or Provisions.** In the event the vesting schedule is amended, or the Plan is amended in any way that directly or indirectly affects the computation of the Participant's vested percentage, those Participants with at least three Years of Service may elect to have their non-forfeitable percentage computed without regard to the amendment. For this purpose, a shift between the Top-Heavy vesting schedule and the non-Top-Heavy vesting schedule shall be deemed an amendment to the vesting schedule.

The period during which the election may be made shall commence with the date the amendment is adopted or deemed to be made and shall end on the latest of: (a) 60 days after the amendment is adopted; (b) 60 days after the amendment becomes effective, or (c) 60 days after the Participant is issued a written notice of the amendment by the Institution or the Plan administrator.

Article VII: Benefits

- 7.1 **Retirement Benefits.** A Participant who has terminated employment may elect to receive retirement benefits under any of the forms of benefit, as provided below.
- 7.2 **Forms of Benefit.** The forms of benefit are the benefit options offered by the Funding Vehicles available under this Plan. These forms are equally available to all Participants choosing the Funding Vehicle. The forms of benefit available under this Plan include:
- i) Single life annuities as provided under the Funding Vehicle contract.
 - ii) Joint and survivor annuities as provided under the Funding Vehicle contract.
 - iii) Fixed period annuities, to the extent the Funding Vehicle permits.
 - iv) Retirement Transition Benefit.
 - v) Repurchase, subject to the limitations in the 'Repurchase' section of this Article.
 - vi) Such other annuity and withdrawal options as provided under the Funding Vehicle contract.
- 7.3 **Cash Withdrawals.** A Participant who has terminated employment may receive benefits in any form the relevant Funding Vehicle permits, including a cash withdrawal.
- 7.4 **Retirement Transition Benefit.** Unless the Joint and Survivor Annuity, the Minimum Distribution Annuity, or the Limited Periodic Withdrawal Option is elected, a Participant may elect to receive a one-time lump-sum payment of up to 10 percent of his or her Accumulation Account(s) in TIAA and/or the CREF account(s) at the time annuity income begins, provided the one-sum payment from each TIAA contract and/or CREF account(s) doesn't exceed 10 percent of the respective Accumulation Account(s) being converted to retirement income.
- 7.5 **Survivor Benefits.** If a Participant dies before the start of retirement benefit payments, the full current value of the Accumulation Account(s) is payable to the Beneficiary(ies) under the options offered by the Funding Vehicle. Distribution of Survivor Benefits is subject to the required distribution rules set forth in Code Section 401(a)(9).
- 7.6 **Application for Benefits.** Procedures for receipt of benefits are initiated by writing directly to the Fund Sponsor. Benefits will be payable by the Fund Sponsor upon receipt of a satisfactorily completed application for benefits and supporting documents. The necessary forms will be provided to the Participant, the surviving spouse, or the Beneficiary(ies) by the Fund Sponsor.
- 7.7 **Minimum Distribution Requirements.** The provisions of this Section will apply for purposes of determining required minimum distributions for calendar years beginning with the 2003 calendar year. The requirements of this Section shall apply to any distribution of a Participant's vested Accumulation Account(s) and will take precedence over any inconsistent provisions of this Plan. Distributions in all cases will be made in accordance with Code Section 401(a)(9) and the regulations promulgated thereunder.
- (A) **Time and Manner of Distribution.**
- (1) **Required Beginning Date.** The Participant's entire interest shall be distributed, or begin to be distributed, to the Participant no later than the Participant's Required Beginning Date.
 - (2) **Death of Participant Before Distributions Begin.** If the Participant dies before distributions begin, the Participant's entire interest shall be distributed, or begin to be distributed, no later than as follows:
 - a) If the Participant's surviving spouse is the Participant's sole designated Beneficiary, then distributions to the surviving spouse shall begin by December 31 of the

calendar year immediately following the calendar year in which the Participant died, or by December 31 of the calendar year in which the Participant would have attained age 70 1/2, if later.

- b) If the Participant's surviving spouse is not the Participant's sole designated Beneficiary, then distributions to the designated Beneficiary shall begin by December 31 of the calendar year immediately following the calendar year in which the Participant died.
- c) If there is no designated Beneficiary as of September 30 of the year following the year of the Participant's death, the Participant's entire interest shall be distributed by December 31 of the calendar year containing the fifth anniversary of the Participant's death.
- d) If the Participant's surviving spouse is the Participant's sole designated Beneficiary and the surviving spouse dies after the Participant but before distributions to the surviving spouse begin, this subsection (A)(2), other than subsection (A)(2)(a), will apply as if the surviving spouse were the Participant.

For purposes of subsections (A)(2) and (C), unless subsection (A)(2)(d) applies, distributions are considered to begin on the Participant's Required Beginning Date. If subsection (A)(2)(d) applies, distributions are considered to begin on the date distributions are required to begin to the surviving spouse under subsection (A)(2)(a). If distributions under an annuity purchased from an insurance company irrevocably commence to the Participant before the Participant's Required Beginning Date (or to the Participant's surviving spouse before the date distributions are required to begin to the surviving spouse under subsection (A)(2)(a), the date distributions are considered to begin is the date distributions actually commence.

- (3) ***Forms of Distribution.*** Unless the Participant's interest is distributed in the form of an annuity purchased from an insurance company or in a single sum on or before the Required Beginning Date, as of the first distribution calendar year distributions shall be made in accordance with subsections (B) and (C) of this Section. If the Participant's interest is distributed in the form of an annuity purchased from an insurance company, distributions thereunder will be made in accordance with the requirements of Code Section 401(a)(9) and the Treasury Regulations.

(B) ***Required Minimum Distributions During Participant's Lifetime.***

- (1) ***Amount of Required Minimum Distribution for Each Distribution Calendar Year.***
During the Participant's lifetime, the minimum amount that will be distributed for each distribution calendar year is the lesser of:
 - a) the quotient obtained by dividing the Participant's account balance by the distribution period in the Uniform Lifetime Table set forth in Treasury Regulation Section 1.401(a)(9)-9, using the Participant's age as of the Participant's birthday in the distribution calendar year; or
 - b) if the Participant's sole designated Beneficiary for the distribution calendar year is the Participant's spouse, the quotient obtained by dividing the Participant's account balance by the number in the Joint and Last Survivor Table set forth in Treasury Regulation Section 1.401(a)(9)-9, using the Participant's and spouse's attained ages as of the Participant's and spouse's birthdays in the distribution calendar year.
- (2) ***Lifetime Required Minimum Distribution Through Year of Participant's Death.***

Required minimum distributions will be determined under this subsection (B) beginning with the first distribution calendar year and up to and including the distribution calendar year that includes the Participant's date of death.

(C) ***Required Minimum Distributions After Participant's Death.***

(1) ***Death On or After Date Distributions Begin***

- a) ***Participant Survived by Designated Beneficiary.*** If the Participant dies on or after the date distributions begin and there is a designated Beneficiary, the minimum amount that will be distributed for each distribution calendar year after the year of the Participant's death is the quotient obtained by dividing the Participant's account balance by the longer of the remaining life expectancy of the Participant or the remaining life expectancy of the Participant's designated Beneficiary, determined as follows:
 - (i) The Participant's remaining life expectancy is calculated using the age of the Participant in the year of death, reduced by one for each subsequent year.
 - (ii) If the Participant's surviving spouse is the Participant's sole designated Beneficiary, the remaining life expectancy of the surviving spouse is calculated for each distribution calendar year after the year of the Participant's death using the surviving spouse's age as of the spouse's birthday in that year. For distribution calendar years after the year of the surviving spouse's death, the remaining life expectancy of the surviving spouse is calculated using the age of the surviving spouse as of the spouse's birthday in the calendar year of the spouse's death, reduced by one for each subsequent calendar year.
 - (iii) If the Participant's surviving spouse is not the Participant's sole designated Beneficiary, the designated Beneficiary's remaining life expectancy is calculated using the age of the Beneficiary in the year following the year of the Participant's death, reduced by one for each subsequent year.
- b) ***No Designated Beneficiary.*** If the Participant dies on or after the date distributions begin and there is no designated Beneficiary as of September 30 of the year after the year of the Participant's death, the minimum amount that shall be distributed for each distribution calendar year after the year of the Participant's death is the quotient obtained by dividing the Participant's account balance by the Participant's remaining life expectancy calculated using the age of the Participant in the year of death, reduced by one for each subsequent year.

(2) ***Death Before Date Distributions Begin***

- a) ***Participant Survived by Designated Beneficiary.*** If the Participant dies before the date distributions begin and there is a designated Beneficiary, the minimum amount that shall be distributed for each distribution calendar year after the year of the Participant's death is the quotient obtained by dividing the Participant's account balance by the remaining life expectancy of the Participant's designated Beneficiary, determined as provided in Section 8.3(a).
- b) ***No Designated Beneficiary.*** If the Participant dies before the date distributions begin and there is no designated Beneficiary as of September 30 of the year

following the year of the Participant's death, distribution of the Participant's entire interest shall be completed by December 31 of the calendar year containing the fifth anniversary of the Participant's death.

- c) ***Death of Surviving Spouse Before Distributions to Surviving Spouse are Required to Begin.*** If the Participant dies before the date distributions begin, the Participant's surviving spouse is the Participant's sole designated Beneficiary, and the surviving spouse dies before distributions are required to begin to the surviving spouse under subsection (A)(2)(a), this subsection (C)(2) shall apply as if the surviving spouse were the Participant.

(D) ***Definitions***

- (1) ***Designated Beneficiary.*** The individual who is designated as the Beneficiary under the Plan and is the designated Beneficiary under Code Section 401(a)(9) and Treasury Regulation Section 1.401(a)(9)-1, Q&A-4.
- (2) ***Distribution calendar year.*** A calendar year for which a minimum distribution is required. For distributions beginning before the Participant's death, the first distribution calendar year is the calendar year immediately preceding the calendar year which contains the Participant's Required Beginning Date. For distributions beginning after the Participant's death, the first distribution calendar year is the calendar year in which distributions are required to begin under subsection (A)(2). The required minimum distribution for the Participant's first distribution calendar year shall be made on or before the Participant's Required Beginning Date. The required minimum distribution for other distribution calendar years, including the required minimum distribution for the distribution calendar year in which the Participant's Required Beginning Date occurs, will be made on or before December 31 of that distribution calendar year.
- (3) ***Life expectancy.*** Life expectancy as computed by use of the Single Life Table in Treasury Regulation Section 1.401(a)(9)-9.
- (4) ***Participant's Account Balance.*** The Participant's account balance as of the last valuation date in the calendar year immediately preceding the distribution calendar year (valuation calendar year) increased by the amount of any contributions made and allocated or forfeitures allocated to the Participant's account balance as of dates in the valuation calendar year after the valuation date and decreased by distributions made in the valuation calendar year after the valuation date. The Participant's account balance for the valuation calendar year includes any amounts rolled over or transferred to the Plan either in the valuation calendar year or in the distribution calendar year if distributed or transferred in the valuation calendar year.
- (5) ***Required Beginning Date.*** The Required Beginning Date of a Participant is April 1 following the calendar year in which the Participant attains age 70 1/2 or if later, April 1 following the calendar year in which the Participant retires.

(E) ***Election to Allow Participants, Former Participants or Beneficiaries to Elect 5-Year Rule.***

Participants or Beneficiaries may elect on an individual basis whether the 5-year rule or the life expectancy rule in subsections (A)(2) and (C)(2) applies to distributions after the death of a Participant who has a designated Beneficiary. The election must be made no later than the earlier of September 30 of the calendar year in which distribution would be required to begin under Subsection (A)(2), or by September 30 of the calendar year which contains the fifth anniversary of the Participant's (or, if applicable, surviving spouse's) death. If neither the Participant nor Beneficiary makes an election under this paragraph, distributions will be made in accordance with subsection (A)(2) and (C)(2).

(F) ***Election to Allow Designated Beneficiary Receiving Distributions Under 5-Year Rule to Elect Life Expectancy Distributions.***

A designated Beneficiary who is receiving payments under the 5-year rule may make a new election to receive payments under the life expectancy rule until December 31, 2003, provided that all amounts that would have been required to be distributed under the life expectancy rule for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003 or the end of the 5-year period.

7.8 ***Repurchase.*** A Participant's accumulations in TIAA-CREF Retirement Annuities may be received in a single sum through "repurchase" if certain conditions are met. If a Participant in this Plan terminates employment with the Institution and requests that TIAA-CREF repurchase his or her Retirement Annuities, the Institution will approve such repurchase if, at the time of the request, all of the following conditions apply:

1. The total TIAA Traditional Annuity accumulation in all Retirement Annuities owned by the Participant is not over \$2,000.
2. The Participant does not have a TIAA Transfer Payout Annuity (TPA) in effect.

Amounts paid to the Participant on repurchase will be in full satisfaction of the Participant's and his or her spouse's rights to retirement or survivor benefits from TIAA-CREF attributable to such amounts.

7.9 ***Direct Rollovers.*** This section applies to distributions made on or after January 1, 1993. Notwithstanding any provision of the Plan to the contrary that would otherwise limit a distributee's election under this section, a distributee may elect, at the time and in the manner prescribed by the plan administrator, to have any portion of an eligible rollover distribution paid directly to an eligible retirement plan specified by the distributee in a direct rollover.

For this section, the following definitions apply:

- 1) **Eligible rollover distribution:** An eligible rollover distribution is any distribution of all or any portion of the balance to the credit of the distributee, except that an eligible rollover distribution does not include: any distribution that is one of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the distributee or the joint lives (or joint life expectancies) of the distributee and the distributee's designated beneficiary, or for a specified period of ten years or more; any distribution to the extent such distribution is required under Code Section 401(a)(9); the portion of any distribution that is not includable in gross income (determined without regard to the exclusion for net unrealized appreciation with respect to employer securities); and, for any distributions after 12/31/99, any hardship distributions described in Code Section 401(k)(2)(b)(i)(iv).
- (2) **Eligible retirement plan:** An eligible retirement plan is an individual retirement account described in Code Section 408(a), an individual retirement annuity described in section 408(b) of the Code, or a qualified retirement plan described in Code Section 401(a) or 403(a) of the Code, that accepts the distributee's eligible rollover distribution. However, in the case of an eligible rollover distribution to the surviving spouse, an eligible retirement plan is an individual retirement account or individual retirement annuity.
- 3) **Distributee:** A distributee includes an employee or former employee. In addition, the employee's or former employee's surviving spouse and the employee's or former employee's spouse or former spouse who is the alternate payee under a qualified domestic relations order, as defined in section 414(p) of the Code, are distributees with regard to the interest of the spouse or former spouse.
- 4) **Direct rollover:** A direct rollover is a payment by the Plan to the eligible retirement plan specified by the distributee.

Article VIII: Administration

- 8.1 **Plan Administrator.** The Institution, located at 2760 Research Park Drive, P.O. Box 11910, Lexington, KY 40578-1910, is the administrator of this Plan and is responsible for enrolling Participants, sending Plan Contributions for each Participant to the Fund Sponsors, and for performing other duties required for the operation of the Plan.
- 8.2 **Authority of the Institution.** The Institution has all the powers and authority expressly conferred upon it herein and further shall have discretionary and final authority to determine all questions concerning eligibility and contributions under the Plan, to interpret and construe all terms of the Plan, including any uncertain terms, and to determine any disputes arising under and all questions concerning administration of the Plan. Any determination made by the Institution shall be given deference, if it is subject to judicial review, and shall be overturned only if it is arbitrary or capricious. In exercising these powers and authority, the Institution will always exercise good faith, apply standards of uniform application, and refrain from arbitrary action. The Institution may employ attorneys, agents, and accountants as it finds necessary or advisable to assist it in carrying out its duties. The Institution, by action of its Board, may designate a person or persons other than the Institution to carry out any of its powers, authority, or responsibilities. Any delegation will be set forth in writing.
- 8.3 **Action of the Institution.** Any act authorized, permitted, or required to be taken by the Institution under the Plan, which has not been delegated in accordance with the "Authority of the Institution" section of Article VIII, may be taken by a majority of the members of the Board, either by vote at a meeting, or in writing without a meeting. All notices, advice, directions, certifications, approvals, and instructions required or authorized to be given by the Institution under the Plan will be in writing and signed by either (i) a majority of the members of the Board, or by any member or members as may be designated by an instrument in writing, signed by all members, as having authority to execute the documents on its behalf, or ii) a person who becomes authorized to act for the Institution in accordance with the provisions of the "Authority of the Institution" section of Article VIII. Any action taken by the Institution that is authorized, permitted, or required under the Plan and is in accordance with Funding Vehicles contractual obligations are final and binding upon the Institution, and all persons who have or who claim an interest under the Plan, and all third parties dealing with the Institution.
- 8.4 **Indemnification.** The Institution will satisfy any liability actually and reasonably incurred by any members of the Board or any person to whom any power, authority or responsibility of the Institution is delegated pursuant to the "Authority of the Institution" section of Article VIII (other than the Fund Sponsors). These liabilities include expenses, attorney's fees, judgments, fines, and amounts paid in connection with any threatened, pending or completed action, suit or proceeding related to the exercise (or failure to exercise) of this authority. This is in addition to whatever rights of indemnification exist under the articles of incorporation, regulations or by-laws of the Institution, under any provision of law, or under any other agreement.
- 8.5 **No Reversion.** Under no circumstances or conditions will any Plan Contributions of the Institution revert to, be paid to, or inure to the benefit of, directly or indirectly, the Institution. However, if Plan Contributions are made by the Institution by mistake of fact, these amounts may be returned to the Institution within one year of the date that they were made.
- 8.6 **Statements.** The Institution will determine the total amount of contributions to be made for each Participant from time to time on the basis of its records and in accordance with the provisions of this Article. When each contribution payment is made by the Institution, the Institution will prepare a statement showing the name of each Participant and the portion of the payment that is made for him or her, and will deliver the statement to the appropriate Fund Sponsors with the contributions payment. Any determination by the Institution, evidenced by a statement delivered to the Fund Sponsors, is final and binding on all Participants, their Beneficiaries or contingent annuitants, or any other person or persons claiming an interest in or derived from

the contribution's payment.

- 8.7 **Reporting.** Records for each Participant under this Plan are maintained on the basis of the Plan Year. At least once a year the Fund Sponsors will send each Participant a report summarizing the status of his or her Accumulation Account(s) as of December 31 each year. Similar reports or illustrations may be obtained by a Participant upon termination of employment or at any other time by writing directly to the Fund Sponsors.

Article IX: Amendment and Termination

- 9.1 ***Amendment and Termination.*** While it is expected that this Plan will continue indefinitely, the Institution reserves the right to amend, otherwise modify, or terminate the Plan, or to discontinue any further contributions or payments under the Plan, by resolution of its Board. In the event of a termination of the Plan or complete discontinuance of Plan Contributions, the Institution will notify all Participants of the termination. As of the date of complete or partial termination, all Accumulation Accounts will become nonforfeitable to the extent that benefits are accrued.
- 9.2 ***Limitation.*** Notwithstanding the provisions of the "Amendment and Termination" section of Article IX, the following conditions and limitations apply:
- (a) No amendment will be made which will operate to recapture for the Institution any contributions previously made under this Plan. However, Plan Contributions made based on a mistake of fact may be returned to the Institution within one year of the date on which the Plan Contribution was made. Also, Plan Contributions made in contemplation of approval by the Internal Revenue Service may be returned to the Institution if the Internal Revenue Service fails to approve the Plan.
 - (b) No amendment will deprive, take away, or alter any then accrued right of any Participant insofar as Plan Contributions are concerned.

Article X: Miscellaneous

- 10.1 **Plan Non-Contractual.** Nothing in this Plan will be construed as a commitment or agreement on the part of any person to continue his or her employment with the Institution, and nothing in this Plan will be construed as a commitment on the part of the Institution to continue the employment or the rate of compensation of any person for any period, and all employees of the Institution will remain subject to discharge to the same extent as if the Plan had never been put into effect.
- 10.2 **Claims of Other Persons.** The provisions of the Plan will not be construed as giving any Participant or any other person, firm, or corporation, any legal or equitable right against the Institution, its officers, employees, or directors, except the rights as specifically provided for in this Plan or created in accordance with the terms and provisions of this Plan.
- 10.3 **Merger, Consolidation, or Transfers of Plan Assets.** In the event of a merger or consolidation with, or transfer of assets to, another plan, each Participant will receive immediately after such action a benefit under the plan that is equal to or greater than the benefit he or she would have received immediately before a merger, consolidation, or transfer of assets or liabilities.
- 10.4 **Finality of Determination.** All determinations with respect to the crediting of Years of Service under the Plan are made on the basis of the records of the Institution, and all determinations made are final and conclusive upon employees, former employees, and all other persons claiming a benefit interest under the Plan. Notwithstanding anything to the contrary contained in this Plan, there will be no duplication of Years of Service credited to an employee for any one period of his or her employment.
- 10.5 **Non-Alienation of Retirement Rights or Benefits.** No benefit under the Plan may, at any time, be subject in any manner to alienation, encumbrance, the claims of creditors or legal process to the fullest extent permitted by law. No person will have power in any manner to transfer, assign, alienate, or in any way encumber his or her benefits under the Plan, or any part thereof, and any attempt to do so will be void and of no effect. However, this Plan will comply with any judgment, decree or order which establishes the rights of another person to all or a portion of a Participant's benefit under this Plan to the extent that it is a "qualified domestic relations order" under section 414(p) of the Code.

Employer Identification Number: 36-6000818

Plan Number: 001

(Signature of Plan Administrator)

THE COUNCIL OF STATE GOVERNMENTS Tax-Deferred Annuity Plan

This document provides each Participant with a description of the
Institution's Tax-Deferred Annuity Plan.

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This summary was prepared for the participants in The Council of State Governments Tax-Deferred Annuity (TDA) plan. If there's any ambiguity or inconsistency between this summary and the Plan Document, the terms of the Plan Document will govern. With respect to benefits provided by TIAA-CREF annuity contracts or certificates, all rights of a participant under the contracts or certificates will be determined only by the terms of such contracts or certificates.

Employer Identification Number: 36-6000818
Plan Number: 002

Part I: Information About The Plan

1. What is the Council of State Governments Tax-Deferred Annuity (TDA) Plan?

The Council of State Governments (the "Institution") TDA Plan (the "Plan") is a defined contribution plan that operates under Section 403(b) of the Internal Revenue Code (IRC). The Plan was established on October 1, 1945. The Plan is an arrangement allowed under Section 403(b) of the IRC, where employees of tax-exempt organizations can enter into salary reduction agreements with their employers. Under the agreement, a portion of the employee's compensation is applied on a before-tax basis to an annuity contract owned by the employee, rather than being paid directly to the employee. These amounts, together with any earnings, are not subject to federal income tax until they are paid to the employee (or beneficiary) in the form of benefits. Benefits are provided through:

- A. *Teachers Insurance and Annuity Association (TIAA)*. TIAA provides a traditional annuity and a variable annuity (through its real estate account). You can receive more information about TIAA by writing to: TIAA, 730 Third Avenue, New York, NY 10017. You also can receive information by calling 1 800 842-2733.
- B. *College Retirement Equities Fund (CREF)*. CREF is TIAA's companion organization, providing variable annuities. You can receive more information about CREF by writing to: CREF, 730 Third Avenue, New York, NY 10017. You also can receive information by calling 1 800 842-2733.

The Institution is the administrator of the Plan and is responsible for plan operation. The plan year begins on January 1 and ends on December 31.

2. Who is eligible to participate in the Plan?

All eligible employees of the Institution can participate in the Plan. Eligible employee means all employees.

3. When do I become eligible to participate in the Plan?

If you are an eligible employee, you may begin participation in this Plan on the first of the month following employment at the Institution. To participate in this Plan, you must complete the enrollment forms, as well as a Salary Reduction Agreement, and return them to the Institution.

Participation in this Plan is voluntary. You are not required to join the Plan. If you decide to participate in the Plan, you will continue to be eligible for the plan until (a) you cease to be an eligible employee, (b) the plan is terminated, or (c) you stop contributing to the Plan, whichever occurs first.

4. What contributions will be made?

To participate, you must enter into a written salary reduction agreement with the Institution. Under the agreement, your salary paid after the agreement is signed is reduced and the amount of the reduction is applied as premiums to one or more of the funding vehicles you select that are available under this Plan.

You may terminate your salary reduction agreement at any time. Your ability to modify your agreement may be subject to such reasonable restrictions as established by the Plan Administrator.

5. **Is there a limit on contributions?**

Yes. The total amount of contributions made on your behalf for any year will not exceed the limits imposed by IRC Section 415 and 403(b). These limits may be adjusted from time to time. For more information on these limits, contact your plan administrator or fund sponsor.

In addition, salary reduction contributions to this Plan will be further limited by IRC Section 402(g) limit. If you have made salary reduction contributions that exceed the 402(g) limit, you should request a distribution of the excess by notifying the Plan administrator by March 1 of the following year. The excess will be distributed to you by April 15.

6. **Do contributions continue during a paid leave of absence?**

During a paid leave of absence, Plan contributions will continue to be made in accordance with the salary reduction agreement. No contributions will be made during an unpaid leave of absence.

7. **When do my plan contributions become vested (i.e., owned by me)?**

You are fully and immediately vested in the benefits arising from contributions made under this Plan. Such amounts are nonforfeitable.

8. **When may I begin receiving benefits?**

You may elect to receive benefits at any time. However, salary reduction contributions (and any earnings) made to an annuity contract after December 31, 1988, may be withdrawn only when you attain age 59 1/2, terminate employment, die, or become disabled. You also may withdraw your contributions (but not earnings credited on or after January 1, 1989) if you encounter hardship.

Retirement benefits must normally begin no later than April 1 of the calendar year following the year in which you attain age 70 1/2 or, if later, April 1 following the calendar year in which you retire. Failure to begin annuity income by the required beginning date may subject you to a substantial federal tax penalty.

If you die before the distribution of benefits has begun, your entire interest must normally be distributed by December 31 of the fifth calendar year after your death. Under a special rule, death benefits may be payable over the life or life expectancy of a designated beneficiary if the distribution of benefits begins not later than December 31 of the calendar year immediately following the calendar year of your death. If the designated beneficiary is your spouse, the commencement of benefits may be deferred until December 31 of the calendar year that you would have attained age 70 1/2 had you continued to live.

The payment of benefits according to the above rules is extremely important. Federal tax law imposes a 50 percent excise tax on the difference between the amount of benefits required by law to be distributed and the amount actually distributed if it is less than the required minimum amount.

Your fund sponsor will normally contact you several months before the date you scheduled your benefits to begin on your application. You may decide, however, to begin receiving income sooner, in which case you should notify the fund sponsor in advance of that date. Usually, the later you begin to receive payments, the larger each payment will be.

9. What options are available for receiving retirement income?

You may choose from among several income options when you retire. However, if you're married, your right to choose an income option will be subject to your spouse's right (under federal pension law) to survivor benefits as discussed in the next question, unless this right is waived by you and your spouse. The following income options are available:

A Single Life Annuity. This option pays you an income for as long as you live, with payments stopping at your death. A single life annuity provides you with a larger monthly income than other options. This option is also available with a 10, 15, or 20 year guaranteed payment period (but not exceeding your life expectancy at the time you begin annuity income). If you die during the guaranteed period, payments in the same amount that you would have received continue to your beneficiary(ies) for the rest of the guaranteed period.

A Survivor Annuity. This option pays you a lifetime income, and if your annuity partner lives longer than you, he or she continues to receive an income for life. The amount continuing to the survivor depends on which of the following three options you choose:

- *Two-thirds Benefit to Survivor.* At the death of either you or your annuity partner, the payments are reduced to two-thirds the amount that would have been paid if both had lived, and are continued to the survivor for life.
- *Full Benefit to Survivor.* The full income continues as long as either you or your annuity partner is living.
- *Half Benefit to Second Annuitant.* The full income continues as long as you live. If your annuity partner survives you, he or she receives, for life, one-half the income you would have received if you had lived. If your annuity partner dies before you, the full income continues to you for life.

All survivor annuities are available with a 10, 15, or 20 year guaranteed period, but not exceeding the joint life expectancies of you and your annuity partner. The period may be limited by federal tax law.

A Minimum Distribution Option (MDO). The MDO enables participants to automatically comply with federal tax law distribution requirements. With the MDO, you'll receive the minimum distribution that is required by federal tax law while preserving as much of your accumulation as possible. The minimum distribution will be paid to you annually unless you elect otherwise. This option is generally available in the year in which you attain age 70 1/2 or, if later, retire.

10. What are my spouse's rights under this plan to survivor benefits?

If you are married and benefits commenced before your death, your surviving spouse will continue to receive income that is at least half of the annuity income payable during the joint lives of you and your spouse (joint and survivor annuity).

If you die before annuity income begins, your surviving spouse will receive a benefit that is at least half of the full current value of your annuity accumulation, payable in a single sum or under one of the income options offered by the fund sponsor (pre-retirement survivor annuity).

If you are married, benefits must be paid to you as described above, unless your written waiver of the benefits and your spouse's written consent to the waiver is filed with the fund sponsor on a form approved by the fund sponsor.

A waiver of the joint and survivor annuity may be made only during the 90-day period before the commencement of benefits. The waiver also may be revoked during the same period. It may not be revoked after annuity income begins.

The period during which you may elect to waive the pre-retirement survivor benefit begins on the first day of the plan year in which you attain age 35. The period continues until the earlier of your death or the date you start receiving annuity income. If you die before attaining age 35—that is, before you've had the option to make a waiver—at least half of the full current value of the annuity accumulation is payable automatically to your surviving spouse in a single sum, or under one of the income options offered by the fund sponsor. If you terminate employment before age 35, the period for waiving the pre-retirement survivor benefit begins no later than the date of termination. The waiver also may be revoked during the same period.

All spousal consents must be in writing and either notarized or witnessed by a plan representative and contain an acknowledgment by your spouse as to the effect of the consent. All such consents shall be irrevocable. A spousal consent is not required if you can establish to the Institution's satisfaction that you have no spouse or that he or she cannot be located. Unless a Qualified Domestic Relations Order (QDRO), as defined in Code Section 414(p), requires otherwise, your spouse's consent shall not be required if you are legally separated or you have been abandoned (within the meaning of local law) and you have a court order to such effect.

The spousal consent must specifically designate the beneficiary or otherwise expressly permit designation of the beneficiary by you without any further consent by your spouse. If a designated beneficiary dies, unless the express right to designate a new one has been consented to, a new consent is necessary.

A consent to an alternative form of benefit must either specify a specific form or expressly permit designation by you without further consent.

A consent is only valid so long as your spouse at the time of your death, or earlier benefit commencement, is the same person as the one who signed the consent.

If a QDRO establishes the rights of another person to your benefits under this Plan, then payments will be made according to that order. A QDRO may preempt the usual requirements that your spouse be considered your primary beneficiary for a portion of the accumulation.

11. May I receive benefits for a fixed-period after termination of employment?

Yes, subject to your spouse's rights to survivor benefits, you may receive benefits for a fixed-period after termination of employment. The fixed-period option pays you an income over a fixed-period of between five and 30 years.

At the end of the selected period, all benefits will end. If you die during the period, payments will continue in the same amount to your beneficiary for the duration.

Tax law requires that the period you choose not exceed your life expectancy or the joint life expectancy of you and your beneficiary.

12. May I receive a cash withdrawal from the Plan after termination of employment?

Yes, subject to your spouse's rights to survivor benefits, you may receive all of your TIAA and CREF accumulations as a cash withdrawal after you terminate employment.

You can elect to receive your cash withdrawal through a series of systematic payments using TIAA-CREF's Systematic Withdrawal service. This service allows you to specify the amount and frequency of payments. Currently, the initial amount must be at least \$100 per account. Once payments begin, they will continue for the period you specify. You can change the amount and frequency of payments, as well as stop and restart payments as your needs dictate. There is no charge for this service.

13. May I receive a cash withdrawal from the Plan while still employed?

Yes, subject to your spouse's rights to survivor benefits, you may receive a cash withdrawal of salary reduction contributions (and any earnings) made to an annuity contract after December 31, 1988, but only if you are at least age 59 1/2, become disabled, or die. You also may withdraw your accumulations while employed if you encounter hardship. See the answer to the question, "May I receive benefits while employed if I incur a hardship?" for details. Annuity contract accumulations credited before January 1, 1989 are not subject to these restrictions and are available for withdrawal at any time. Please keep in mind that, under current tax law, withdrawals received before you are age 59 1/2 are generally subject to a 10 percent penalty tax, in addition to ordinary income tax.

14. May I receive a cash withdrawal while still employed if I incur a hardship?

Yes. If you incur a hardship before you terminate employment, you may receive a lump-sum cash payment, subject to the restrictions of the funding vehicle.

Hardship distributions will be permitted only if you incur an immediate and heavy financial need and the distribution is necessary to meet the financial need. To be considered for a hardship distribution, you'll need to complete an application form and supply supporting documentation required by the Plan administrator. No earnings credited on or after January 1, 1989 will be available for hardship distributions.

If a hardship distribution is made to you, all employee contributions to any plan maintained by your Institution may be suspended for 12 months after you receive the distribution. In addition to any other limits under this Plan, your maximum permitted contribution under Code Section 402(g) in the next taxable year after the taxable year of the hardship distribution may be reduced by the amount of the hardship distribution. As with any withdrawal, you should consult with your tax advisor since there are possible tax consequences.

15. May I take a loan from the Plan?

Yes. If you are married at the time you request the loan, your spouse must consent to the loan.

The loan will be administered by the applicable fund sponsor. Specific loan provisions for each fund sponsor are described below:

How much you can borrow from TIAA. Generally, the minimum loan amount is \$1,000, and the maximum loan amount is \$50,000. The maximum amount you can borrow may be less, however, depending on two factors: 1) the amount of your GSRA accumulation, and 2) whether you've had any other loans from any of this Institution's plans within the last year.

If you haven't had a plan loan in the previous year, your maximum loan is the least of: 1) \$50,000; or 2) 45 percent of your combined TIAA and CREF GSRA accumulation attributable to participation under this Plan; or 3) 90 percent of your TIAA Traditional Annuity GSRA accumulation attributable to participation under this Plan.

If you've had another loan from *any* plan of this Institution within the last year, the maximum you can borrow will be reduced by that amount. Also, if more than one employer contributed to your Annuities, you can only take loans against the amount you accumulated under this Institution's Plan. You should check with your other employers for their rules on loans.

Securing your loan. You have to set aside an amount equal to 110 percent of your loan in your TIAA GSRA Traditional Annuity accumulation as security for your loan. The security will continue to earn guaranteed interest as well as dividends. You can't make a cash withdrawal or begin retirement income from the funds that serve as security for your loan. But as you repay your loan, the amount reserved as security decreases, and more of your accumulation becomes available to you for withdrawal and retirement income.

If you die before repaying your loan, the remaining loan balance will be repaid from the TIAA Traditional Annuity accumulation set aside as security. Your beneficiaries would receive the balance of your accumulation.

Determining the interest rate. The loan interest rate is variable and can increase or decrease every three months. The interest rate you pay initially will be the higher of 1) the Moody's Corporate Bond Yield Average for the calendar month ending two months before your loan is issued; or 2) the interest rate credited before your annuity starting date, as stated in the applicable rate schedule, plus 1 percent. Thereafter, the rate may change quarterly, but only if the new rate differs from your current rate by at least 1/2 percent.

Repayment. You have from one to five years to repay your loan. There's one exception: if you use the loan solely to purchase your primary residence, you can take up to ten years to repay. The term of the loan usually can't extend past the April 1st of the year after the year you attain age 70 1/2.

Your first payment will be due the first day of the third month after your loan is issued, and every three months thereafter. You can repay your loan early with no penalties. You can also make partial prepayments any time. If you do, whatever you prepay will be applied directly to the principal amount of your loan. (Regularly scheduled payments are applied first to interest, then to principal.) Any prepayments will reduce the *amount* of future repayments, not the *number* of payments.

TIAA offers a free automatic loan repayment service. Your bank will debit your checking account and send your repayment to TIAA on the date it's due. If you prefer to repay your loan directly, TIAA will send you a bill every three months, at least ten days before the payment is due.

Defaults. If TIAA doesn't receive your loan repayment by the last day of the month it's due, you will be in default. Currently, it appears that the amount in default will be the missed payment plus all interest accrued to date. However, it is possible that your entire loan balance will be considered in default if you miss one payment.

To the extent permitted by federal tax law, TIAA will deduct the amount in default from the collateral held in the TIAA GSRA Traditional Annuity and apply it toward repaying the loan. It's very important to keep in mind, however, that the IRS requires TIAA to report the default amount as income you actually received. That means defaults are taxable as ordinary income in the year they occur. If you're under age 59 1/2, your default may also be subject to an additional 10 percent federal tax penalty. TIAA assumes no responsibility for the tax consequences resulting from loan defaults.

Tax law may prohibit TIAA from deducting the default amount from your accumulation until you reach age 59 1/2, terminate employment, become disabled, or die, whichever occurs first. In these cases, you'll be taxed on the default amount as if you received it as income in the year the default occurred. Interest accrues on the total amount in default and you're taxed on this interest each year until TIAA is able to deduct the defaulted amount from your accumulation to repay the loan.

To apply for a loan or for more information. To apply for a loan or to get answers to any questions you may have about loans, call TIAA-CREF's Telephone Counseling Center toll-free at 1 800 842-2776.

16. May I roll over my accumulations?

If you're entitled to receive a distribution from your contract which is an eligible "rollover distribution," you may roll over all or a portion of it either directly or within 60 days after receipt into another Section 403(b) retirement plan or into an IRA. An eligible rollover distribution, in general, is any cash distribution other than an annuity payment, a minimum distribution payment or a payment which is part of a fixed period payment over ten or more years. The distribution will be subject to a 20 percent federal withholding tax *unless* it's rolled over directly into another retirement plan or into an IRA—this process is called a "direct" rollover.

If you have the distribution paid to you, then 20 percent of the distribution must be withheld even if you intend to roll over the money into another retirement plan or into an IRA within 60 days. To avoid withholding, instruct the fund sponsor to directly roll over the money for you.

17. What if I die before starting to receive benefits?

If you die before beginning retirement benefits, the full current value of your annuity accumulation is payable as a death benefit. You may choose one or more of the options listed in your annuity contracts for payment of the death benefit, or you may leave the choice to your beneficiary. The payment options include:

- Income for the lifetime of the beneficiary with payments ceasing at his or her death.
- Income for the lifetime of the beneficiary, with a minimum period of payments of either 10, 15, or 20 years, as selected.

- Income for a fixed period of not less than five nor more than 30 years as elected, but not longer than the life expectancy of the beneficiary;
- A single sum payment.
- A minimum distribution option. This option pays the required federal minimum distribution each year.
- The accumulation may be left on deposit, for up to one year, for later payment under any of the options.

Federal tax law puts limitations on when and how beneficiaries receive their death benefits. TIAA-CREF will notify your beneficiary of the applicable requirements at the time he or she applies for benefits.

You should review your beneficiary designation periodically to make sure the person you want to receive the benefits is properly designated. You may change your beneficiary by completing the "Designation of Beneficiary" form available from TIAA-CREF. If you die without having named a beneficiary and you are married at the time of your death, your spouse will automatically receive half of your accumulation. Your estate will receive the other half. If you're not married, your estate receives the entire accumulation.

In addition, see the answer to the question "What are my spouse's rights under this plan to survivor benefits?" for a discussion of your spouse's rights to a survivor benefit if you are married at the time of your death.

Part II: Information About The Fund Sponsors

1. What fund sponsors and funding vehicles are available under the Plan?

Contributions may be invested in one or more of the following fund sponsors and their funding vehicles that are currently available under this Plan:

A. Teachers Insurance and Annuity Association (TIAA):

TIAA Group Supplemental Retirement Annuity (GSRA):

Traditional Annuity
Real Estate Account

B. College Retirement Equities Fund (CREF):

CREF Group Supplemental Retirement Unit-Annuity (GSRA):

Stock Account
Money Market Account
Bond Market Account
Social Choice Account
Global Equities Account
Growth Account
Equity Index Account
Inflation Linked Bond Account

Any additional Accounts offered by TIAA-CREF will automatically be made available to you under this plan.

The Institution's current selection of fund sponsors and funding vehicles isn't intended to limit future additions or deletions of fund sponsors and funding vehicles. You'll be notified of any additions or deletions.

2. How do the retirement contracts work?

TIAA Traditional Annuity: Contributions to the TIAA Traditional Annuity are used to purchase a contractual or guaranteed amount of future retirement benefits for you. Once purchased, the guaranteed benefit of principal plus interest cannot be decreased, but it can be increased by dividends. Once you begin receiving annuity income, your accumulation will provide an income consisting of the contractual, guaranteed amount plus dividends that are declared each year and which are not guaranteed for the future. Dividends may increase or decrease, but changes in dividends are usually gradual. For a recorded message of the current interest rate for contributions to the TIAA Traditional Annuity, call the Automated Telephone Service (ATS) at 1 800 842-2252. The ATS is available 24 hours a day, seven days a week.

CREF and the TIAA Real Estate Account: You have the flexibility to accumulate retirement benefits in any of the CREF variable annuity accounts approved for use under the Plan, as indicated above, and the TIAA Real Estate Account. Each account has its own investment objective and portfolio of securities. Contributions to a CREF account and the

TIAA Real Estate Account are used to buy accumulation units, or shares of participation in an underlying investment portfolio. The value of the Accumulation Units changes each business day. You may also choose to receive annuity income under any of the CREF accounts and the TIAA Real Estate Account. There is no guaranteed baseline income or declared dividends when you receive annuity income from these accounts. Instead, your income is based on the value of the annuity units you own, a value that changes yearly, up or down. For more information on the CREF accounts, you should refer to the CREF prospectus. For more information about the TIAA Real Estate Account, refer to the TIAA Real Estate Account prospectus.

For a recorded message of the latest accumulation unit values for the CREF Accounts and TIAA Real Estate Account, as well as the seven-day yield for the CREF Money Market Account, call the ATS at 1 800 842-2252. The recording is updated each business day.

3. How do I allocate my contributions?

You may allocate contributions among the TIAA Traditional Annuity, the TIAA Real Estate Account, and the CREF Accounts in any whole-number proportion, including full allocation to any Account. You specify the percentage of contributions to be directed to the TIAA Traditional Annuity, the TIAA Real Estate Account, and/or the CREF Accounts on the "Enrollment Form for TIAA-CREF Group Supplemental Retirement Annuity Certificates" when you begin participation. You may change your allocation of future contributions at any time after participation begins by calling the ATS toll free at 1 800 842-2252. When you receive your certificates, you'll also be sent a Personal Identification Number (PIN). The PIN enables you to change your allocation by using the ATS. For more information on allocations, ask for the TIAA-CREF booklet *Guiding Your Retirement Savings*.

4. May I transfer my accumulations?

You may transfer your TIAA-CREF accumulations among the TIAA Traditional Annuity, the TIAA Real Estate Account, and the CREF Accounts. Total transfers of your accumulation may be made at any time. Partial transfers may be made at any time as long as at least \$1,000 is transferred each time. There's no charge for transferring accumulations in the TIAA-CREF system.

You may complete transfers within the TIAA-CREF system either by phone or in writing. CREF and TIAA Real Estate Account transfers, as well as premium allocation changes, will be effective as of the close of the New York Stock Exchange (usually 4:00 p.m. Eastern time) on the day the instructions are received by TIAA-CREF, unless you choose the last day of the current month or any future month. Instructions received after the close of the New York Stock Exchange are effective as of the close of the Stock Exchange on the next business day. The toll-free number to reach the ATS is 1 800 842-2252.

5. May I begin my retirement income at different times?

Yes. Once you decide to receive your benefits as income, you have the flexibility to begin income from the TIAA Traditional Annuity, the TIAA Real Estate Account and CREF accounts on different dates. You may begin income from each CREF account and the TIAA Real Estate Account on more than one date provided you begin income from at least \$10,000 of accumulation in that account.

6. May I receive my retirement accumulations under different income options?

Yes, under current administrative practice, you can elect to receive income from your TIAA and CREF annuities under more than one income option to meet your specific retirement needs. However, you must begin income from at least \$10,000 of accumulation under each option.

7. What information do I regularly receive about my contracts?

Each year, you will receive an annual Annuity Benefits Report from TIAA-CREF that shows the total accumulation value at year-end for your contracts. This is the amount of death benefits your spouse or other beneficiary would have received on that date. It also includes an illustration of the annuity income you would receive at retirement under certain stated assumptions as to future premiums, your retirement age, the income option and payment method selected, TIAA Traditional Annuity dividends, and the investment experience of the TIAA Real Estate Account and the CREF accounts. These factors affect the amount of your retirement income.

TIAA-CREF also sends you a Quarterly Confirmation of Transactions. This report shows the accumulation totals, a summary transactions made during the period, TIAA interest credited, and the number and value of TIAA Real Estate Account and CREF account accumulation units. You also may receive Premium Adjustment Notices. These notices summarize any adjustments made to your annuities and are sent at the time the adjustments are processed.

And once a year, you'll receive the TIAA-CREF Annual Report. The Annual Report summarizes the year's activity, including details on TIAA and CREF investments, earnings, and investment performance.

Part III: Additional Information

1. **How is the Plan administered?**

Benefits under the plan are provided by annuity contracts issued to Participants by TIAA-CREF. The Institution is the Plan Administrator and is responsible for enrolling participants, forwarding Plan contributions for each participant to the fund sponsors selected, and performing other duties required for operating the Plan.

2. **May the terms of the Plan be changed?**

While it's expected that the Plan will continue indefinitely, the Institution reserves the right to modify or discontinue the Plan at any time. The Institution, by action of its Board, also may delegate any of its power and duties with respect to the Plan or its amendments to one or more officers or other employees of the Institution. Any such delegation shall be stated in writing. The Institution will exercise good faith, apply standards of uniform application, and refrain from arbitrary action.

3. **How do I get more information about the Plan?**

Requests for information about the Plan and its terms, conditions and interpretations including eligibility, participation, contributions, or other aspects of operating the Plan should be in writing and directed to:

The Council of State Governments
P.O. Box 11910
Lexington, Kentucky 40578

4. **What is the Plan's claims procedure?**

The following rules describe the claims procedure under the Plan:

- **Filing a claim for benefits:** A claim or request for plan benefits is filed when the requirements of a reasonable claim-filing procedure have been met. A claim is considered filed when a written communication is made to Council of State Governments.
- **Processing the claim:** The Plan Administrator must process the claim within 90 days after the claim is filed. If an extension of time for processing is required, written notice must be given to you before the end of the initial 90-day period. The extension notice must indicate the special circumstances requiring an extension of time and the date by which the Plan expects to render its final decision. In no event can the extension period exceed a period of 90 days from the end of the initial 90-day period.
- **Denial of claim:** If a claim is wholly or partially denied, the Plan Administrator must notify you within 90 days following receipt of the claim (or 180 days in the case of an extension for special circumstances). The notification must state the specific reason or reasons for the denial, specific references to pertinent plan provisions on which the denial is based, a description of any additional material

the steps to be taken if you wish to submit the claim for review. If notice of the denial of a claim is not furnished within the 90/180-day period, the claim is considered denied and you must be permitted to proceed to the review stage.

- **Review procedure:** You or your duly authorized representative has at least 60 days after receipt of a claim denial to appeal the denied claim to an appropriate named fiduciary or individual designated by the fiduciary and to receive a full and fair review of the claim. As part of the review, you must be allowed to review all plan documents and other papers that affect the claim and must be allowed to submit issues and comments and argue against the denial in writing.

- **Decision on review:** The Plan must conduct the review and decide the appeal within 60 days after the request for review is made. If special circumstances require an extension of time for processing (such as the need to hold a hearing if the plan procedure provides for such a hearing), you must be furnished with written notice of the extension, which can be no later than 120 days after receipt of a request for review. The decision on review must be written in clear and understandable language and must include specific reasons for the decision as well as specific references to the pertinent plan provisions on which the decision is based. For a Plan with a committee or board of trustees designated as the appropriate named fiduciary, a decision does not have to be made within the 60-day limit if the committee or board meets at least four times a year (about every 90 days). Instead, it must be made at the first meeting after the request is filed, except that when a request is made less than 30 days before a meeting, the decision can wait until the date of the second meeting following the Plan's receipt of request for review. If a hearing must be held, the committee can wait to decide until the first meeting after the hearing. However, it must notify you and explain the delay, which can be no later than the third meeting of the committee or board following the Plan's receipt of the request for review. If the decision on review is not made within the time limits specified above, the appeal will be considered denied. All interpretations, determinations, and decisions of the reviewing entity with respect to any claim will be its sole decision based upon the Plan documents and will be deemed final and conclusive. If appeal is denied, in whole or in part, however, you have a right to file suit in a state or federal court.

5. What are my rights under the law?

As a participant in the Plan, you are entitled to certain rights and protections under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA provides that all Plan participants are entitled to:

1. Examine, without charge, at the Plan Administrator's office all documents, including insurance contracts, and copies of all documents filed by the Plan with the U.S. Department of Labor, such as annual reports and Plan descriptions.
2. Obtain copies of all plan documents and other plan information upon written request to the Plan Administrator. The Administrator may make a reasonable charge for the copies.
3. Receive a summary of the Plan's annual financial report. The Plan Administrator is required by law to furnish you with a summary of the Plan's financial report.
4. Obtain a statement telling whether you have a right to receive a pension at normal retirement age and if so, what your benefits would be at normal retirement age

retirement age and if so, what your benefits would be at normal retirement age if you stop working under the Plan now. If you do not have the right to a pension, the statement will tell you how many more years you have to work to get a right to a pension. This statement must be requested in writing and is not required to be given more than once a year. The Plan must provide the statement free of charge.

In addition to creating rights for Plan participants, ERISA imposes duties upon the people who are responsible for operating the Plan. The people who operate your Plan, called "fiduciaries" of the Plan, have a duty to do so prudently and in the interest of you and other Plan participants and beneficiaries. No one, including your employer, your union, or any other person, may fire you or otherwise discriminate against you in any way to prevent you from obtaining a pension benefit or exercising your rights under ERISA. If your claim for a pension benefit is denied in whole or in part, you must receive a written explanation of the reason for the denial. You have the right to have the Plan review and reconsider your claim.

Under ERISA, there are steps you can take to enforce the above rights. For instance, if you request materials from the Plan and don't receive them within 30 days, you may file a suit in a federal court. In such a case, the court may require the Plan Administrator to provide the materials and pay you up to \$100 a day until you receive the materials, unless the materials were not sent because of reasons beyond the control of the Administrator. If you have a claim for benefits that is denied or ignored in whole or in part, you may file suit in a state or federal court.

If the Plan fiduciaries misuse the Plan's money, or if you're discriminated against for asserting your rights, you may seek assistance from the U.S. Department of Labor, or you may file suit in a federal court. The court will decide who should pay court costs and legal fees. If you are successful, the court may order the person you have sued to pay these costs and fees. If you lose, the court may order you to pay these costs and fees, for example, if it finds your claim is frivolous. If you have any questions about your Plan, you should contact the Plan Administrator. If you have any questions about this statement or about your rights under ERISA, you should contact the nearest Area Office of the U.S. Pension and Welfare Benefits Administration, Department of Labor.

6. Is the Plan insured by the Pension Benefit Guaranty Corporation (PBGC)?

No. Since the Plan is a defined contribution plan, it isn't insured by the PBGC. The PBGC is the government agency that guarantees certain types of benefits under covered plans.

7. Who is the agent for service of legal process?

The agent for service of legal process is: The Council of State Governments.

Attachment 12

Documentation of the source of funds CSG intends to use to pay the full actuarial cost.



December 21, 2015

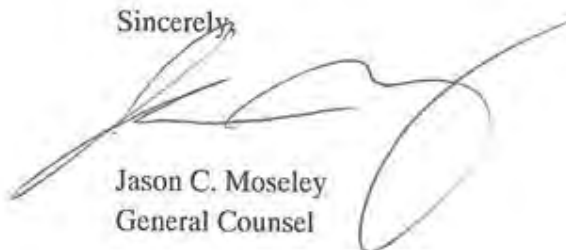
Bill Thielen, Executive Director
Kentucky Retirement Systems
Perimeter Park West
1260 Louisville Road
Frankfort, KY 40601-6124

RE: Payment of full actuarial cost by lump sum

Mr. Thielen,

This correspondence is in accordance with 105 KAR 1:145, Section 4(2)(j), regarding how the Council of State Governments ("CSG") intends to pay for the full actuarial cost resulting from ceasing to participate in the Kentucky Employees Retirement System. CSG intends to pay for the actuarial cost in a lump sum payment. Depending on the amount of the actuarial cost, CSG intends to pay for this from CSG's liquid reserves and, to the extent the actuarial costs exceed CSG's liquid reserves, the remainder will be financed privately through a local financial institution. Once the estimated actuarial cost is provided under 105 KAR 1:145(2), CSG will be able to provide more detail on how that lump sum will be delivered to the Kentucky Retirement Systems.

Sincerely,



Jason C. Moseley
General Counsel

The Council of State Governments National Headquarters

2790 Research Park Drive • Lexington, KY 40513-8482 • (859) 244-8000 • Fax (859) 244-8001 • www.csg.org

Eastern Office
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www.csg-east.org

Midwestern Office
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(630) 925-1977
www.csgmidwest.org

Southern Office
Atlanta
(404) 633-1866
www.csgsouth.org

Western Office
Denver, CO
(303) 553-4473
www.csgwest.org

Washington Office
Washington, DC
(202) 778-1888
www.csgdc.org

KENTUCKY RETIREMENT SYSTEMS

TO: Members of the Board

FROM: William A. Thielen
Executive Director

DATE: February 18, 2016

SUBJECT: Hazardous Member Insurance Premium Issue – Failure to File Form 6256

As you are aware, KRS hazardous duty members were notified via the Open Enrollment materials mailed in the Fall of 2015 and by a separate memorandum mailed in December 2015 that they were required to submit the KRS Form 6256 verifying the eligibility of a spouse or dependent children by December 31, 2015 to continue to receive the KRS premium contribution for beneficiary health insurance for the 2016 plan year. Additionally, most KRS hazardous duty members with dependent children received a separate certified letter regarding the same issue.¹

KRS hazardous duty members who failed to remit the Form 6256 by December 31, 2015 only received a contribution amount to off-set the individual members' health insurance premium for January, and in some cases February, 2016. The costs of additional couple or family coverage were deducted from the member's benefit.

Some affected members contacted KRS, remitted the required Form 6256, and were notified that they could file a grievance regarding the insurance premium deduction. If a grievance was filed and KRS determined that there was an error or failure to properly advise the member on the part of KRS, the benefit deduction has been refunded. To-date, 111 grievances have been denied and 52 have been granted. Approximately 20 additional grievances are being reviewed.

The issue is whether KRS should grant an "exemption" to KRS hazardous duty members who did not remit Form 6256 in a timely manner and refund all of the corresponding premium deductions. If the Board determines that a blanket exemption is appropriate, it should establish the parameters of the current exemption and how KRS should administer the verification requirement on a "go forward" basis.

RECOMMENDATION: None at this time.

¹ Copies of Form 6256 and information on this issue published on KRS' website are attached to this memorandum.